INPUT

STRATEGIC MARKET PERSPECTIVE

The Role of the CFO in Outsourcing Decisions

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U.S. Outsourcing Program

APRIL 1994

The Role of the CFO in Outsourcing Decisions

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M&S 459/01 2/94

Abstract

The decision to outsource some or all of a firm's information systems activities is invariably made at the executive management level. Even in organizations where decision making is decentralized, the impact of the decision to outsource is significant enough that in most instances, the chief executive officer (CEO) and chief operating officer (COO) are likely to become involved in the process. Most outsourcing vendors, however, report the officer likely to play the dominant role is the chief financial officer (CFO) both in terms of initiating the investigation of the outsourcing alternative and managing the overall selection process.

The Role of the CFO in Outsourcing Decisions is based on in-depth discussions with CFOs from major corporations and identifies the actual role the CFO plays in the outsourcing decision process. In addition, the report analyzes the following issues:

- How CFOs relate to the information systems function and other officers involved in the outsourcing decision

- The types of data, models and analytical tools used in the evaluation and selection process

- The level of satisfaction with the outsourcing results

- How vendors can improve their positioning in terms of the selection and on-going contract management processes

The Role of the CFO in Outsourcing Decisions analyzes the role and perception of **the key decision maker** in the outsourcing purchase process—the CFO. This report provides invaluable information for all sales and marketing professionals that provide, or plan to provide, outsourcing services.

This report contains 76 pages and 29 exhibits and was prepared as part of INPUT's Outsourcing Information Services Program

Published by
INPUT
1881 Landings Drive
Mountain View, CA 94043-0848
United States of America

Outsourcing Information Systems Program

The Role of the CFO in Outsourcing Decisions

OS4 • 426 • 1993

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I Introduction

The decision to outsource some or all of a company's data processing activities is almost invariably made at the executive management level. Even in organizations where decision making is highly decentralized, the impact of the decision to outsource is significant enough, that in most instances, chief executive and chief operating officers (CEOs and COOs) are likely to become involved in the process However, most outsourcing vendors report the officer likely to play the dominant role is the CFO (chief financial officer) in terms of initiating the investigation of the outsourcing alternative and managing the overall selection process.

A Objectives

The principal objective of this study is to gain a better understanding of the role of the CFO in all aspects of the outsourcing decision making process, including:

- Initiation of the examination of the outsourcing alternative
- Participation in the analysis and vendor selection process
- Involvement in the on-going management of outsourcing agreements

In addition to gaining an understanding of the CFO's role, the study also addresses the following issues.

- How CFOs relate to the information systems function and other officers involved in the outsourcing decision

- The types of data, models and analysis tools used in the evaluation and selection process
- The level of satisfaction with the results of outsourcing
- How vendors can improve their positioning in terms of the selection and on-going contract management processes

B
Scope

Although some of the companies participating in the study have outsourcing agreements that cover domestic and foreign operations, the scope of the study is limited to contracts initiated in the U.S. The types of outsourcing agreements included all four major categories of outsourcing services listed below and further defined in Appendix B.

- Platform operations
- Applications management
- Network management
- Desktop services

The survey data used in the study is from firms representing a broad base of industry sectors within the United States.

C
Methodology/Demographics

1. Methodology

- In-depth telephone surveys were conducted with senior officers of 26 firms. In some instances multiple interviews were done within a single company in order to gather all the required information.
- CFOs were contacted in all cases. In some instances they referred part of the interview to the head of IS or another company officer. In three cases interviews were conducted via conference calls with the CIO and CFO both participating in the discussion.
- Companies targeted for participation in the study came from two sources. The primary source was INPUT's outsourcing database, containing information on over 400 U.S. outsourcing agreements.

As a secondary source, major outsourcing vendors were contacted and asked to recommend companies to participate in the survey. A total of eight of the twenty-six completed surveys were obtained using this source. The vendors providing prospective respondents included EDS, Systematics, Genix, CSC and DEC.

- To gain additional insight into the outsourcing decision making process, an informal interview was conducted with a consulting firm that specializes in assisting companies in selecting and contracting for data processing-related outsourcing services.

Upon completion of the interviews, the data was coded and tabulated for use in this analysis. This analysis, along with secondary research, and data from other INPUT research on outsourcing was used in the preparation of this report.

2. Demographics

Appendix A contains a listing of 25 of the 26 participating companies. One company chose not to be identified.

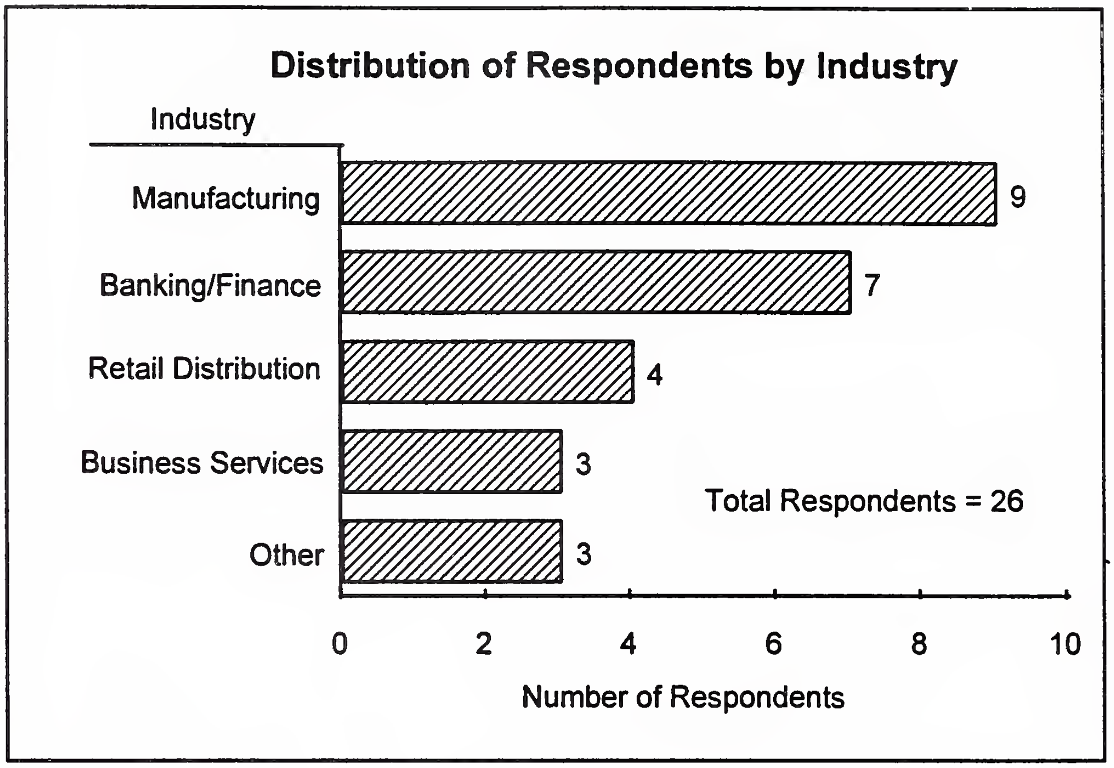
In general, participating companies represent a reasonable cross-section of industry groups as shown in Exhibit I-1.

- For companies in the Banking/Finance sector the average size in terms of assets was $9.6 billion.

- The remaining 19 firms in the sample had average annual sales of $1.4 billion.

The average number of employees per company for the entire sample was approximately 12,000, and is biased slightly on the high side by companies from the retail distribution sector with employee counts generally exceeding 20,000.

EXHIBIT I-1



a. Characteristics of Interviewees

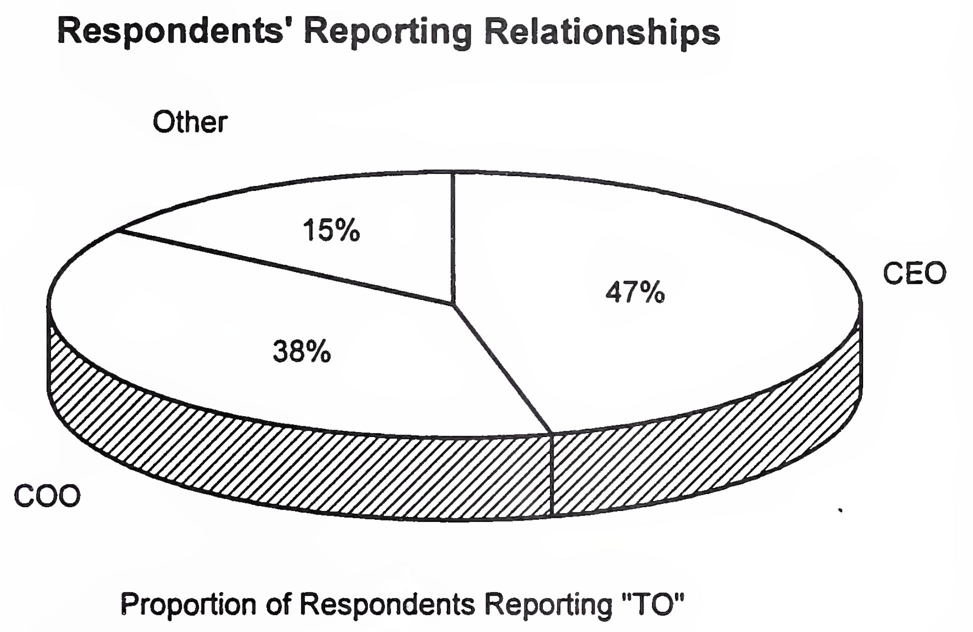
Interviewees were senior officers or members of upper-level management, generally carrying the title of senior vice-president and CFO. Two chief operating officers were interviewed and no one held a title lower than vice president.

As mentioned earlier, CFOs sometimes referred the interview to another senior officer or completed it jointly with the CIO. The net result is a sample breakdown on the basis of responding departments:

- 60% Finance
- 30% Information Systems
- 10% Other

As shown in Exhibit I-2, regardless of title or functional orientation, respondents generally reported to either the CEO or COO.

EXHIBIT I-2



The combination of the senior reporting levels coupled with a reasonable distribution of respondents across business functions yielded very high quality interview results.

b. Vendors, Contract Values and Types of Service

A variety of vendors are providing outsourcing services to the companies in the sample.

- The vendor with the largest showing was ISSC. In total, ISSC is in place in six of the twenty-two companies surveyed. In two of these instances they have joint arrangements, one with Ernst & Young, and another with Andersen Consulting to provide application management services.

- Vendors serving the other 20 contracts are as follows:

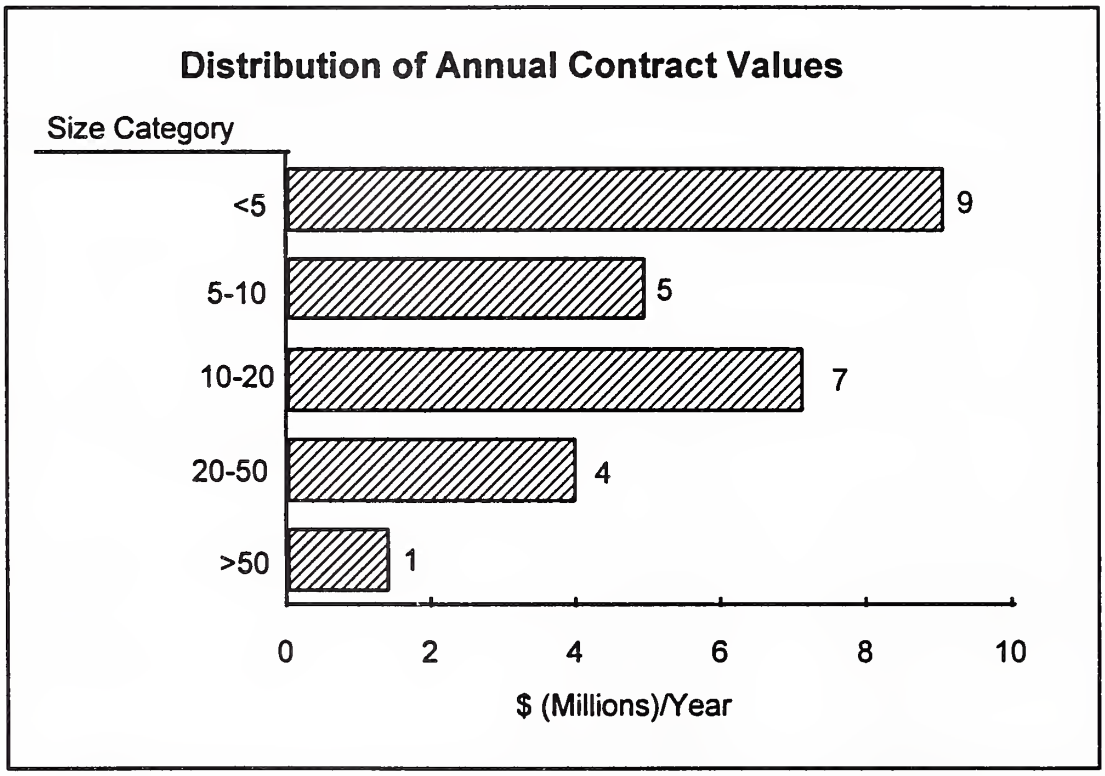
  - 5 - EDS
  - 5 - Systematics
  - 4 - GENIX
  - 1 - ACS, Andersen Consulting, Perot, DEC, INET and CSC

The sizes of the agreements in terms of overall contract value and average annual anticipated expenditures vary significantly within the sample.

- The average overall contract value was $132 million
- The average annual expenditure for the sample was $13.7 million
- The average contract life was approximately 7.5 years

Exhibit I-3 shows the distribution of annual contract values for the survey sample by size category.

EXHIBIT I-3

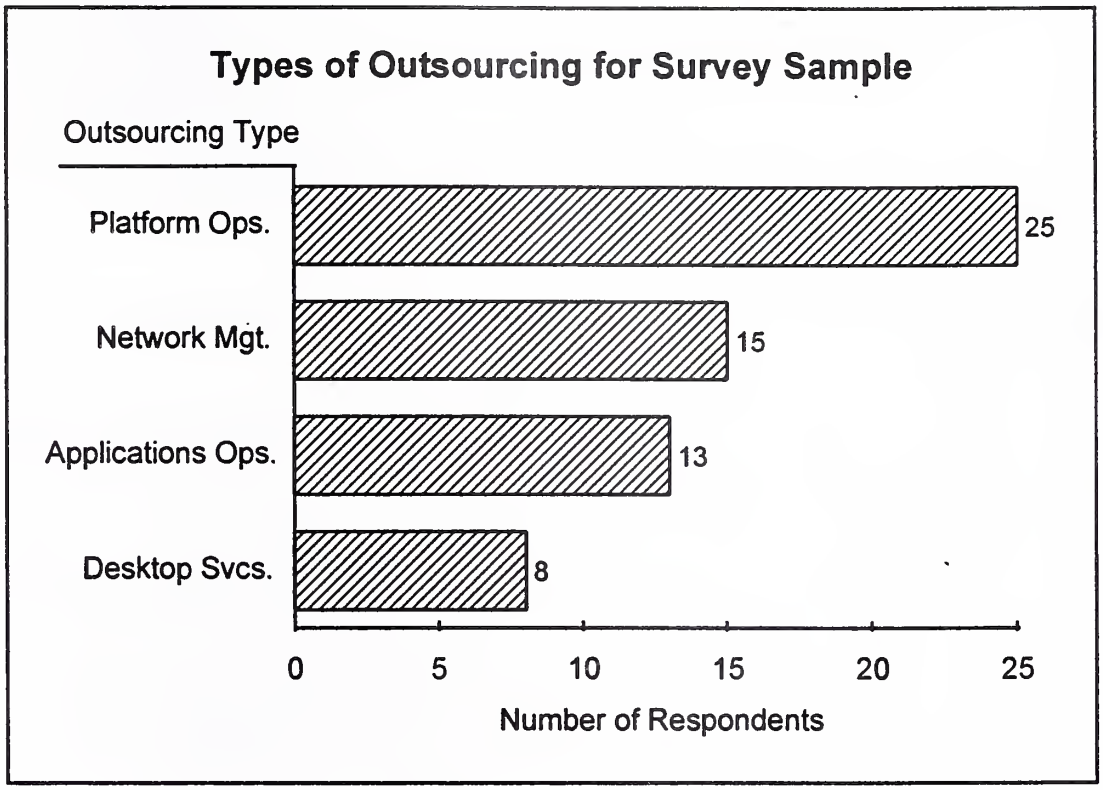


A closer examination of the data shows that the smaller agreements tend to be with small banks and service companies while the largest ones occur in major manufacturing, banking and large retail distribution firms.

All types of outsourcing services are covered in the agreements represented in the sample. All but one of the companies surveyed has outsourced platform operations with just over half the sample also outsourcing network services and or applications management.

Exhibit I-4 shows the number of firms that have outsourced each type of service.

EXHIBIT I-4



Overall, the sample is well balanced, representing both large and small firms as well as a variety of different types of agreements.

D
Organization

The remainder of the report is organized into four chapters:

- Chapter II, *Executive Overview* provides a synopsis of the findings of this study along with recommendations.

- Chapter III, *The Evaluation and Selection Process*, presents INPUT's analysis of how the decision to outsource is initiated and the roles that various organizations and managers play in the evaluation, vendor selection and contracting process. There is also a detailed discussion of models used in the process.

- Chapter IV, *Ongoing Management of Outsourcing Agreements*, discusses the roles that various organizations and managers play in the

ongoing management of outsourcing agreements; including communications and vendor performance measurement.

- Chapter V, *Experience and Benefits*, focuses on the degree of satisfaction that companies have with their outsourcing partnerships, and identifies things that they would have done differently were they making the decision today.

E
Related Reports

Other reports on the outsourcing market which may be of interest to the reader are:

- *U.S. Information Systems Outsourcing Markets, 1993-1998 (1994)*
- *Client Satisfaction with Outsourcing Contracts (1994)*
- *Business Operations Outsourcing (1993)*
- *IS Outsourcing Competitive Analysis (1993)*
- *Desktop Services—User Perspectives (1994)*

II

Executive Overview

Outsourcing all or a major part of a company's IS activities is a major decision, frequently requiring board-level approval, and almost invariably the active participation of a company's senior executive management. From an outsourcing vendor's perspective it is important to understand:

- Why and how the decision to outsource is made
- The processes and criteria used in evaluating and selecting vendors
- The roles played by various functions in the decision making process
- The metrics used in managing outsourcing agreements

This study provides insight into these questions and issues from the viewpoint of the buyer. The study examines the roles of all corporate officers and functions in the outsourcing process. However, special emphasis is placed on the role of the CFO and the financial function, since:

- Financial considerations are most frequently the motivation for considering outsourcing IS, or for that matter, other functions.

- It is widely believed in the information services industry that the CFO is the key member of the executive group influencing the outcome.

An overview of the project, summary of findings and INPUT's recommendations follow.

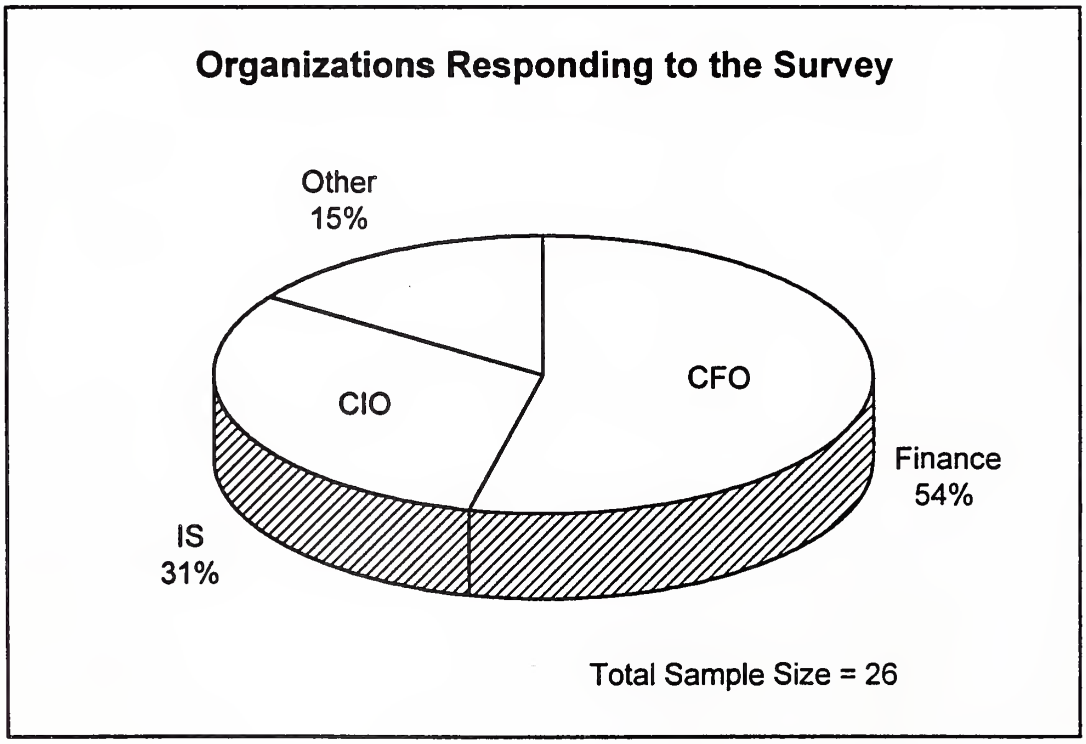
A
Introduction

INPUT conducted telephone interviews with 26 major corporations within the United States to obtain the information used in this study. All had outsourced some major part of their data processing over the past three years.

- The companies interviewed represent all major industry sectors. *Appendix* A contains a list of companies that participated in the study.

- CFOs were contacted to be interviewees. In some instances they referred INPUT to the CIO or another corporate officer for completion of the interview. Joint interviews (CIO and CFO) were conducted with three of the companies. Exhibit II-1 shows the proportion of interviews obtained from finance, IS and other organizations.

EXHIBIT II-1



- Companies in the sample outsourced various aspects of their systems activities; 24 - platform operations, 15 - network management, 13 - applications operations and 7 - desktop services.

The data collected included information on:

- Company organization and background
- How the outsourcing decision was made
- Ongoing contract management responsibilities
- Experience and benefits
- Contract characteristics

Appendix B contains a copy of the complete questionnaire.

B

Findings

Analysis of the data provides considerable insight into various aspects of the outsourcing decision making and management processes. The summary of the findings is organized into six sections.

- Deciding to Outsource
- Vendor Evaluation, Selection and Contract Negotiations
- Ongoing Management of the Agreement
- The Use of Modeling and Metrics
- Other Findings
- The Role of the CFO—Summary

1. Deciding to Outsource

This survey's results confirm previous INPUT research, pointing to cost reduction either in total budget, or on a unit of service basis, as the most significant factor motivating companies to consider outsourcing. Respondents rated cost reduction as a 4.3 on a scale of 1 to 5 (5 High) as a primary objective. But other considerations also play a role.

- Obtaining rapid access to more advanced technologies is a strong consideration, and the factor most frequently considered as a secondary objective.

- Corporate restructuring or downsizing programs have an impact. In about 50% of the companies surveyed, outsourcing was considered as part of a corporate program to examine all noncore business functions. In these situations achieving a savings is important, but not as important as in situations where outsourcing IS is treated as a standalone decision.

Factors that do not appear to have a strong influence include the general dissatisfaction with IS performance and direct vendor solicitations. Only two companies of the twwnty-six looked to outsourcing because their systems functions were out of tune with corporate objectives. Moreover, direct vendor solicitation of the business rated a poor 1.5 (5 High) as an influence on the decision to outsource.

When it comes to initiating the examination of outsourcing, the CFO clearly plays an key role. In fact, the CFO initiated the outsourcing process in 50% of the companies included in the sample. But, contrary to popular opinion, this is seldom done without the knowledge or cooperation of the CIO. CIOs were involved from the earliest stages in 24 of the 26 companies surveyed.

2. Vendor Evaluation, Selection and Contract Negotiations

a. Project Organization and Management

Companies tend to take a project team approach to the evaluation and selection process. This was the case in 20 out of the 26 companies surveyed. Even when formal project organizations are not established, the organization placed in charge uses a multidisciplinary approach, calling on internal company experts to participate in various phases of the evaluation and selection process.

Consultants also play an important role as evaluation team members. Sixty percent of the companies surveyed used outside consultants as part of the evaluation and selection process to provide.

- Overall direction to the process
- Systems planning expertise
- Expertise on performance analysis and IS metrics
- Legal expertise
- Technical knowledge
- Negotiating strategies

b. Evaluation and Selection

Companies go through a common evaluation and selection process regardless of industry or size. The study identified an 11 stage process starting with internal assessment and cost analysis and ending with the selection decision itself. Analysis on a phase-by-phase basis shows almost

every company goes through nine of the eleven phases. The two phases likely to be skipped are:

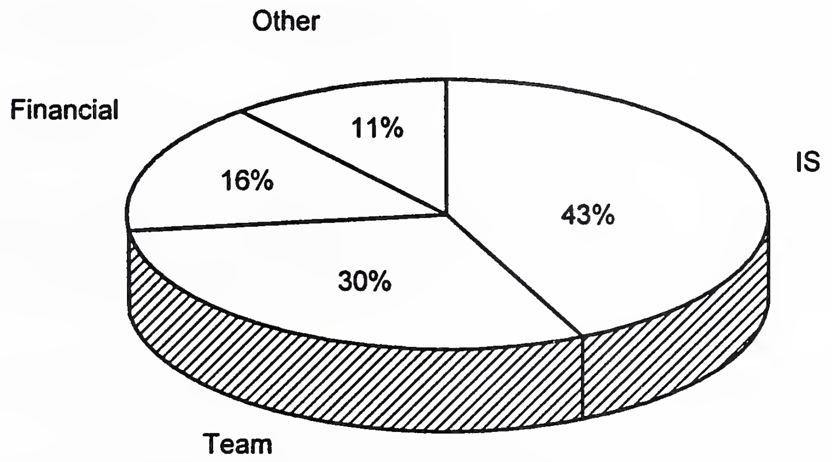
- Holding a formal bidding conference. (Bidding conferences were held by only 11 out of 26 respondents)

- Developing evaluation models. (Twenty of 26 respondents developed formal models with capabilities beyond standard spreadsheet analysis.)

The CIO, or equivalent systems executive, is the prime candidate to mange the process. IS was identified as the overall project leader in close to 50% of the sample, with the financial function taking the lead in more than 16% of the cases. Also, IS dominates the leadership of most of the individual phases. As shown in Exhibit II-2, IS took responsibility for 43% of the project phases undertaken by companies in the sample.

EXHIBIT II-2

Proportion of Outsourcing Project Phases Managed by Various Organizations



Total Project Phases = 257

Although finance doesn't dominate the management of many of the phases, it has a heavy influence on three phases of the process which are critical to arriving at a final selection. They are:

- The initial internal cost analysis
- The development of proposal evaluation models
- The evaluation of vendor proposals

c. Negotiations

Once the selection is made, actual negotiations are usually led by the CIO. This was true in about 50% of the companies in the sample. Finance remains involved, but to a much lesser degree than in the evaluation and selection process, providing:

- Analysis of the proposed financial terms of vendor contracts

- Development of performance criteria to be used for compliance

- The negotiation of specific conditions regarding payments and penalties

3. Ongoing Management of the Agreement

As in evaluation, selection and negotiations, IS also takes leadership in the ongoing management of the typical outsourcing agreement, with the financial and legal function providing support. The CIO or IS executive was assigned responsibility for each of the following ongoing responsibilities in 80% of the companies in the sample.

- Communications concerning the agreement or changes in the relationship

- Administration of the contract including those activities which must be performed on a periodic basis to assure proper billings, etc.

- Monitoring and reporting or service-level measures specified in the agreement

- Renegotiating service levels, etc., throughout the life of the contract and during renewal

Finance plays a secondary role in contract administration and renegotiations, but the bulk of the responsibility goes to the internal systems function.

4. The Use of Modeling and Metrics

a. Modeling

Models beyond simple spreadsheets are likely to be used in greater than 75% of the evaluations. The study identified three classes of models:

- **Financial Comparisons** - Compares the financial characteristics of alternative vendor proposals (usually against an in-house base case) over the life of the proposed agreement. These models usually include analysis of alternate future scenarios and service unit cost projections.

- **Weighted Scoring** - Compares the financial aspects of competing proposals, but also sets parameters for other items such as service-level commitments, disaster recovery provisions, etc. Vendor rankings are developed based on weighting factors assigned to different attributes of the various proposals.

- **Application Scoring** - Develops a comparison of costs for various vendor alternatives based on the projected cost of delivering specific transactions; e.g., paychecks, on a per unit basis over the proposed contract life.

Nine of the survey respondents reported using a weighted scoring model of some type. Six used financial comparison models and only three, application scoring.

In general, models are designed to easily handle the generation of alternate scenarios, or built with "what-if" capabilities for varying key parameters. Some models identified in the study actually used probability distributions of key parameters, with simulations providing probability distributions of outcomes.

Regardless of the type of model, the financial function is likely to take the leadership in model building. However, it usually is a team effort involving IS and, frequently, consultants. This is particularly true for the more sophisticated weighted and application scoring models.

b. Metrics

Obviously, the metrics used by companies to analyze vendor compliance with the service and product delivery commitments vary based on the type of outsourcing covered by the agreement. The typical measures by type of outsourcing are:

- **Platform Operations** - Resources delivered (MIPS, Gigibytes, etc.), system downtime, system response time, batch turnaround and help desk response

- **Applications Operations** - Function points delivered, project phase completions against schedule and staffing level by skill

- **Network Management** - Response time, availability by node, new capacity, recovery time

- **Desktop Services** - Help desk response, installations/upgrades against schedule and field service response

Despite this large variety of metrics, buyers remain uncomfortable with the process of contract compliance measurement for a variety of reasons.

- To a large degree, the metrics tend to evaluate the *processes* of service delivery, and not the results. Buyers sometimes find that things look good "by the numbers", yet service is less than expected.

- Few measurements exist (with the possible exception of those associated with platform and network operations) that reflect service quality or effectiveness. This is particularly true for applications operations.

- Significant amounts of time and effort are expended on defining metrics for processes and services that turn out to be nonproblems, while other more important areas of the relationship have no meaningful measures in place.

Despite these difficulties, metrics remain an important factor in the overall relationship, impacting penalty payments and pricing and influencing the overall tone of the day-to-day working relationship between outsourcers and their customers.

5. Other Findings

- While most companies (92% of those participating in the survey) indicated their outsourcing arrangement met or exceeded their overall expectations, there were some areas where they felt performance was disappointing.
  - Companies outsourcing applications development and maintenance generally scored performance either meeting or falling below anticipated levels for that aspect of the service.
  - Companies whose objectives include migration to new technologies or architectures are frequently disappointed at the pace at which the process proceeds.
- On the positive side:
  - Anticipated financial results are almost always achieved.
  - Most companies are very happy with the degree of flexibility their contracts provide.

Finally, if companies were given a second chance, there appear to be a number of things that they would do differently throughout the evaluation and selection process. The three most frequently mentioned were:

- Investing more time on the front end of the process to assess their current situation and future requirements
- Being more specific about requirements at the RFP stage, and insisting that vendors' proposals respond to requirements directly.
- Taking a more aggressive position about controlling the process.

6. The Role of the CFO—Summary

The CFO plays a significant role in the outsourcing process, but probably not as important as sometimes perceived. The study identified at least two situations where the CFO took leadership throughout the process and clearly controlled the outcome. But, there were two others where the CFO's role was absolutely minimal.

The findings indicate the process is most likely to be managed as a team effort with the CIO or IS assuming most of the project management responsibility and the CFO or finance taking leadership in some key phases.

C
Conclusions and Recommendations

1. Conclusions

- CFOs currently take the leadership role in initiating the consideration of outsourcing as an alternative method of delivering IS services. But, CIOs are increasing taking a proactive role, perceiving outsourcing as a way to make significant technology transitions or resolve staffing and process issues.

- Cost considerations will remain a primary factor in motivating the decision to outsource; but access to advanced technology, including C/S and sophisticated networking services, development methodologies and unique industry expertise will become increasingly important factors in motivating a company to outsource.

- There are few variations in how the decision to outsource is made based on industry or company size. However, there appear to be some variations on how the evaluation and selection process is managed. Specifically, corporate officers, including the CFO, will be less directly involved in large firms.

- Buyers perceive the use of consultants as an asset, if for no other reason than the fact they have been through the process before. As more companies become aware of their availability, it is likely consultants will be used more frequently and throughout a growing number of phases of the process.

- Models play an important role in the evaluation and selection for two reasons:

    - They are the most powerful tools available to buyers to place frequently disparate vendor proposals on a common footing.

- They often provide an analytical characterization of how various factors beyond the financial characteristics of a proposal will be evaluated.

It is likely the use of models will increase over time as buyers become more sophisticated in analyzing vendor proposals.

- The vast majority of companies who outsource find their expectations are being met or exceeded. The highest level of dissatisfaction occurs with applications operations, where the specification of the service and its measurement are less well understood than is the case with hardware- and network-related services.

- Buyers will increasingly look for "results-oriented" metrics as part of their outsourcing agreements, as opposed to measurement systems which assess the service delivery process alone.

- The current rate of evolution of the technology and the emergence of new architectures, will cause buyers to ask for more specific commitments to technology change as part of their agreements.

2. Vendor Recommendations

- Do not underestimate the role of the CIO in evaluation and selection. While the CFO may trigger the evaluation process in most situations, it is usually IS that controls the process once it is initiated.

- Determine how a company currently measures its IS processes. Gain as much insight as possible on the criteria used in any models the company plans to use. Understanding these parameters should permit the generation of a proposal that is understandable and emphasizes those services and concerns of highest interest to the prospect.

- Respond to the RFP on a point-by-point basis, and in the terminology of the RFP. Nothing appears to be more annoying to buyers than decoding the boiler plate they receive in many vendors' proposals. Include a sample contract with the proposal (boiler plate is probably unavoidable here), and make sure that it is easy to relate the specific points in the proposal to the corresponding contract content.

- Be clear on items that are not responded to in the proposal.

- If the response to the RFP contains proposals for products or services not specified in the RFP, make sure these items and their costs are clearly distinguishable from required services.

- If at all possible, include the proposed account manager as part of the marketing team from the RFP phase on. Participating in the process will provide the individual with insight into who committed to what, and speed the transition process.

- Significant business opportunities exist for consulting on the outsourcing process. Demand for consultants with prior experience in helping a company outsource, and an objective reputation, should grow significantly. Consultants should ahve an advantage if they have tools to assist a firm in assessing its situation, and/or models that can be tailored for use in the evaluation process.

- If possible, propose the delivery of specific results within a specific time period. Buyers indicate this adds credibility to the commitment level of the vendor. This approach is particularly important when the agreement will involve applications operations or technology transfer.

III

The Evaluation and Selection Process

The decision to outsource all or part of a company's data processing can be motivated by a variety of business factors, some related directly to the cost and/or performance of the systems function, and others associated with corporate strategy issues. However, once the decision to pursue the outsourcing alternative is made, most companies use a similar process to evaluate and select vendors.

While the process is relatively consistent, the roles various executives and business functions play and the degree of emphasis placed on each step in the process, varies significantly from company to company. This chapter examines the evaluation and selection process in detail from the initial decision to outsource, to the evaluation and selection of a vendor, through the contract negotiations. Particular emphasis is placed on the roles the CFO and the financial function play in the process.

- Section A, *The Outsourcing Decision*, focuses on how and why the decision to consider outsourcing is made.

- Section B, *Vendor Evaluation and Selection*, discusses each major phase of the evaluation and selection process with emphasis on who takes the leadership responsibility for each phase.

- Section C, *Contract Negotiations*, examines how companies organize to finalize outsourcing agreements and the use of outside consultants in the process.

- Section D, *Models and Selection Criteria*, analyzes the types of models used in the evaluation process and key selection criteria.

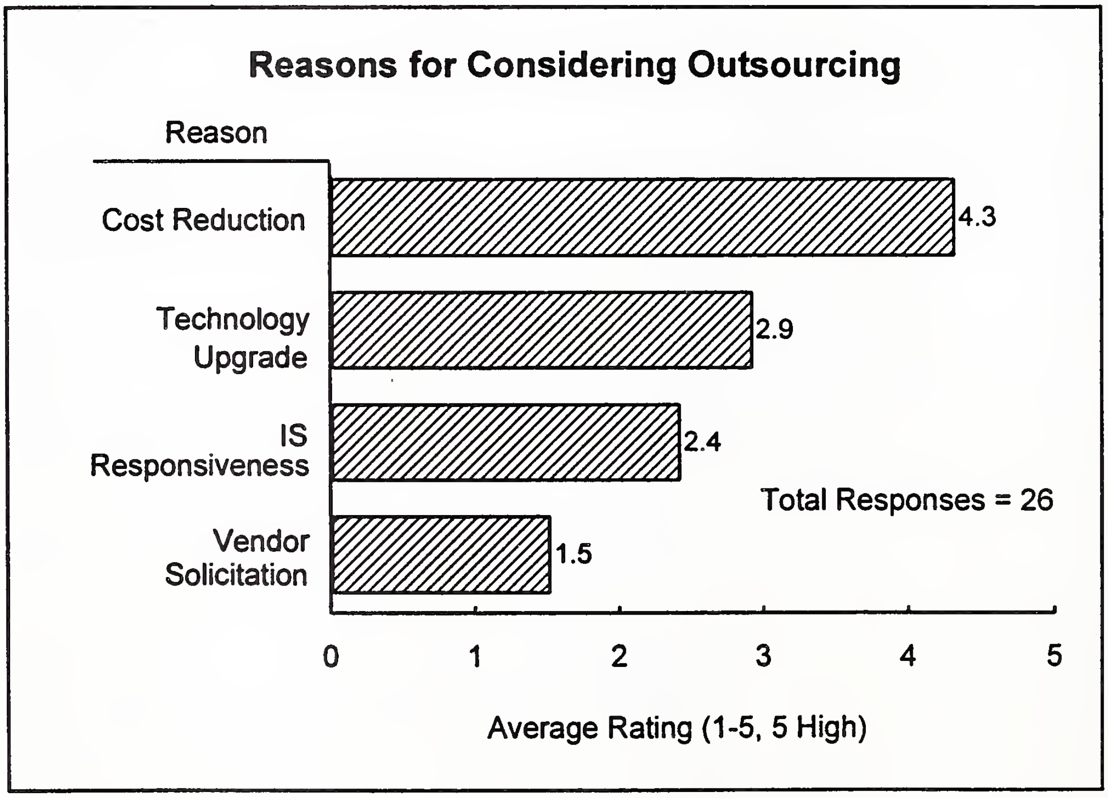
- Section E, *The Role of Consultants*, summarizes the findings on the impact of consultants on the outsourcing decision-making process.

A
The Outsourcing Decision

1. Motivating Factors

While there are many reasons for companies to consider outsourcing as an approach to managing information services, the most important for most firms is to achieve a cost savings, either in absolute annual expenditures or on a unit cost basis. As shown in Exhibit II-1, survey respondents rated the importance of cost reduction at 4.3 on a scale of 1-5 (5 High) as a motivating factor.

EXHIBIT III-1



Although not nearly has highly rated as cost reduction, other factors also play a role. Many firms see outsourcing as an opportunity to upgrade to current technology without the need to make front-end investments in newer or larger hardware, or the cost of retraining in-house staff. In other instances, the motivation is to replace the entire function with an outside organization more responsive to, and in tune with, a company's strategic

information systems requirements. However, neither of these factors is likely to be primary in motivating executive management to consider the outsourcing alternative.

- Of the twenty-six respondents, only three rated technology upgrade a 5 and the primary factor for considering outsourcing.

- Only two companies in the sample state that their primary motivation to outsource was to achieve a higher level of responsiveness and quality from the systems function. Interestingly enough, one of the two was initiated by the CIO.

However, upgrading or achieving a leapfrog in technology clearly is a strong secondary motivator to cost reduction. Virtually all companies in the survey who cited cost reduction as primary, rated improved technology three or higher, and most cited it as a secondary benefit they hoped to achieve through outsourcing.

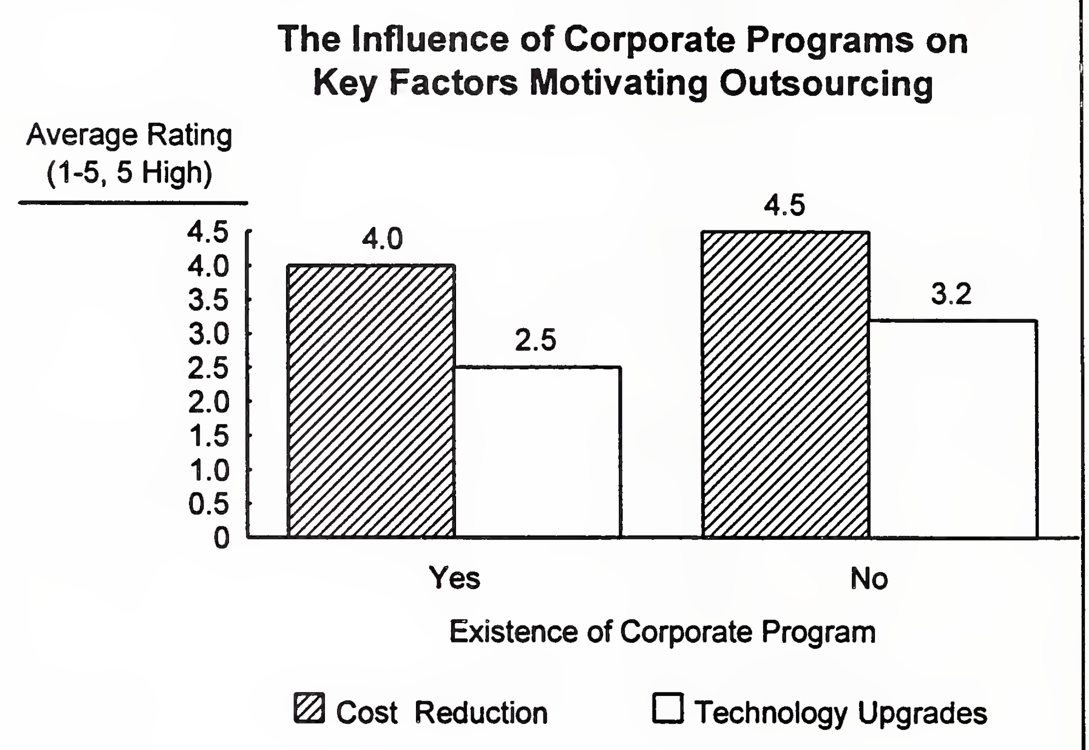
Finally, very few firms felt they were stimulated to consider outsourcing by direct approaches from vendors. In only one instance did a respondent rate the importance of vendor solicitation a 5. This was the only case in the sample where it appears that a hard sell by the vendor to the COO forced a decision to pursue outsourcing.

In general then, it appears the decision to outsource is primarily internally driven, and focused on achieving a total reduction in annual costs or reduced unit costs over some planning horizon. But even with the emphasis on cost, most companies expect to obtain improvements in IS technology, both hard and soft, as a secondary benefit.

2. The Impact of Corporate Business Strategy

Corporate programs to downsize, restructure or re-engineer business activities also have an influence on the decision to outsource information systems. Of the companies surveyed, 50% indicated they had such programs in place when the decision was made to outsource. Exhibit III-2 gives a comparison of the average ratings for cost reduction and technology upgrades on the basis of whether a corporate downsizing or restructuring program was in place. It shows these factors are less significant than they are in cases where the outsourcing of IS is being dealt with as a standalone decision.

EXHIBIT III-2



The likely explanation is that when outsourcing, IS is examined as a standalone decision. Issues relating to technology and cost have a higher profile than when outsourcing is considered as part of an overall corporate program focusing on non-IS specific issues such as returning to core competencies or decentralization of decision making authority.

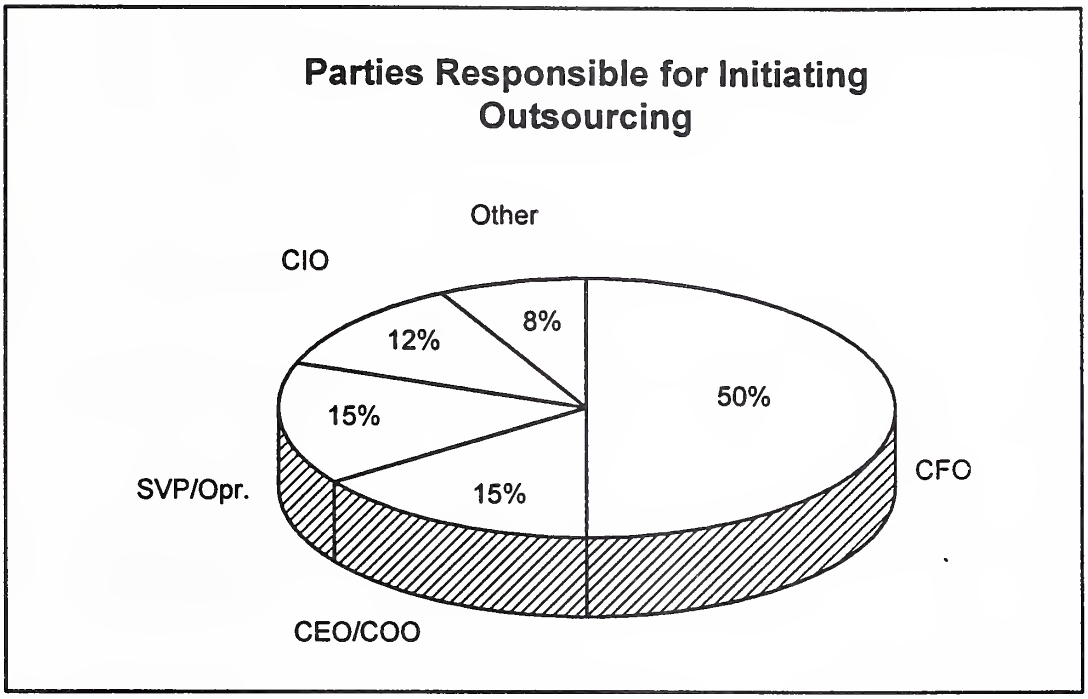
3. The Role of the CFO

Regardless of whether the decision to outsource is a result of an overall corporate program or a single-point decision related to IS, the CFO plays a significant role in initiating the process.

The survey data indicates in 50% of the cases the CFO was directly responsible for initiating the examination of outsourcing, regardless of where the IS function reported. This was true in eight out of the fifteen cases where the function reported to the CFO and in five out of eleven of the cases where the function reported elsewhere in the organization.

Exhibit III-3 shows the proportion of outsourcing deals initiated by various officers.

EXHIBIT III-3



The two cases represented in the other category included the following:

- One where the process was actually initiated by an outside consultant in conjunction with the CIO

- Another where the company was a startup, and the startup team decided to go outside for information systems support rather than build an in-house staff to provide the services

Finally, whether initiated by the CFO or another company officer, almost everyone involves the CIO or equivalent senior executive of the systems function in the decision making process. Twenty-four of thetwenty-six companies in the survey involved IS at the very initiation of the process. The two that didn't clearly regretted it as they moved into evaluation, despite the fact that the IS organizations in these firms were considered woefully inadequate.

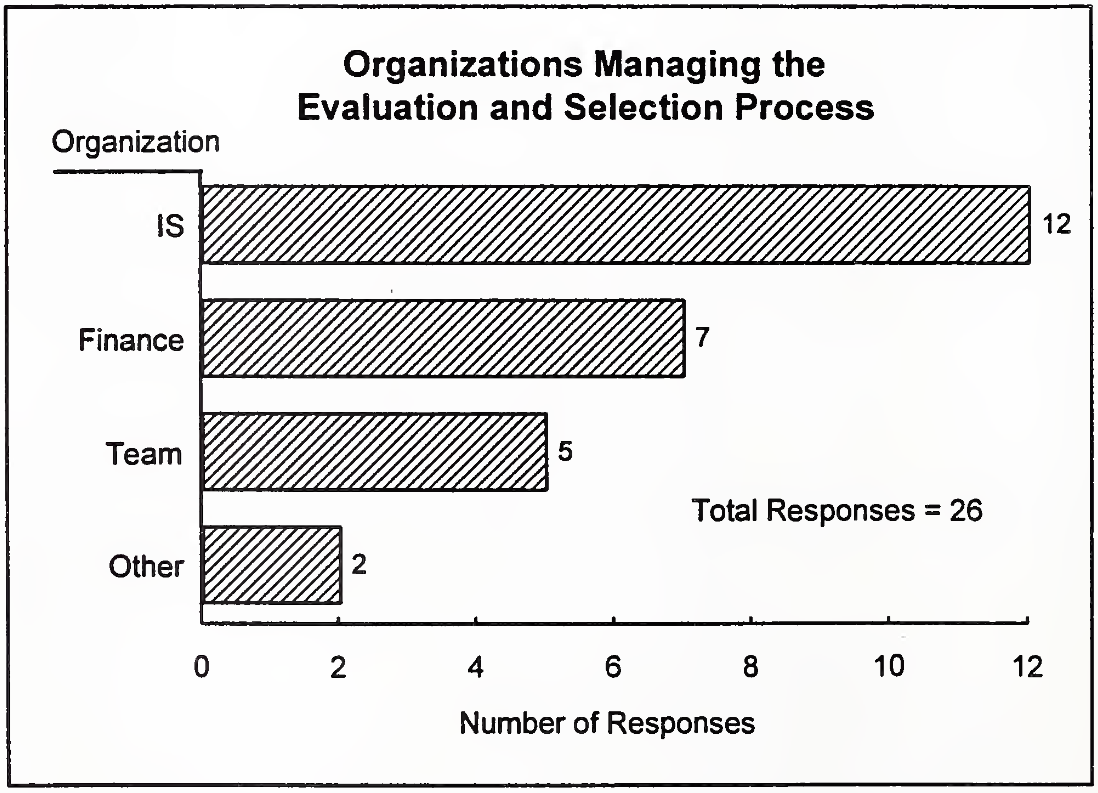
B
Vendor Evaluation and Selection

1. Overall Management Approach

Project Organization - Once the decision to outsource has been made, most companies evaluate and select a vendor using a multidisciplinary team approach and structure the process as a project. Data from the survey sample indicates that 20 out of the 26 evaluations were performed using this approach. In the remaining six, responsibility was assigned to a single organization that relied on support from other company departments for specific expertise.

Project Management - Exhibit III-4 shows the IS function (CIO) is frequently selected to manage the evaluation and selection process with finance being the second most popular organization.

EXHIBIT III-4



Some organizations indicated that the project reported to a team of senior executives who fulfilled the project management requirements. Of the two companies in the "other" category, one firm assigned project management directly to a consultant, and the other to the COO.

Consultants - The use of consultants is relatively common, since for most companies evaluating and selecting an outsourcing vendor is a first time experience. Sixty percent of the sample companies indicated consultants were used, and most were used throughout the entire evaluation and selection process, particularly companies that formed project teams for the evaluation. The types of consultants fall into two categories.

- Legal experts with specific experience in dealing with the creation of outsourcing contracts.

- Process and technical experts who had demonstrable experience at managing the overall process, or specific knowledge in areas such as:

  - Forecasting future technical trends
  - Projecting future resource requirements
  - Establishing measurement criteria

In the later category, a number of firms were specifically mentioned; including, KPMG, Price Waterhouse, Technology Partners, J. P. Kearney, and Deloitte and Touche. The sample is too small to draw any conclusions about who has the largest share of this business, but Technology Partners, Price Waterhouse and KPMG did receive multiple mentions. The areas where consultants were perceived to have provided high value are discussed later in this chapter.

2. The Evaluation Process

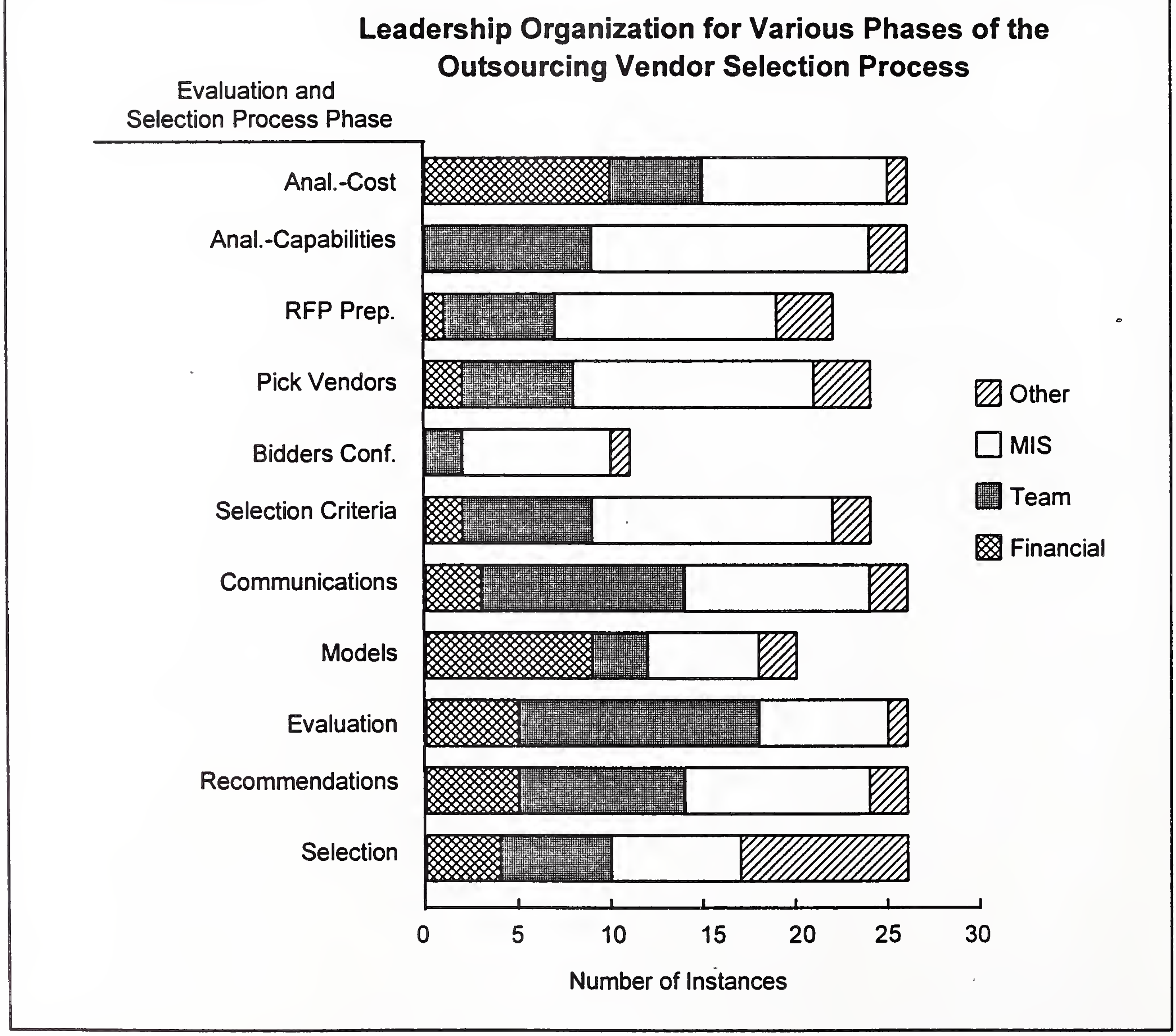
For purposes of this study the evaluation process was divided into 11 steps or activities. Respondents were asked to indicate whether their company actually undertook each activity, who took the leadership role and the influence the financial function or CFO had on the outcome of that activity. The eleven activities were defined as follows:

- Analysis of current systems costs
- Analysis of current systems capabilities and future requirements
- Preparation of requests for proposal
- Selection of vendors invited to submit bids
- Conduct of a bidders' conference
- Development of vendor selection criteria
- Communication with vendors during proposal development
- Development of models for the evaluation of proposals

- Proposal evaluation
- Development of formal recommendations
- Vendor selection

Exhibit III-5 shows the number of instances various organizations took the leadership position in each of the eleven phases of the evaluation and selection process.

EXHIBIT III-5



With the exception of holding a formal bidding conference, most companies in the sample went through all phases of the process. It is also interesting to note that at least four companies out of thetwenty-six did not prepare requests for proposals (RFPs).

In addition to managing the overall process, in close to 50% of the cases, IS appears to provide the leadership for many of the 11 phases shown in Exhibit III-5 with the second most dominant approach being some form of team leadership for an individual phase. There are, however, at least two phases where the financial function plays a significant hands-on role.

- About 40% of the time, finance assumes or is assigned, the responsibility for performing the analyses that forms the base case of projected costs. This case is used to compare vendor proposals to the in-house alternative. The financial function is also generally involved in interpreting the projected costs provided in vendor proposals. However, even in these cases IS expertise is required to interpret the technical information inherent in outsourcing proposals, and critical to making future cost projections.

- Where models are used as part of the evaluation scheme, finance is most frequently the developer and relied on to interpret results.

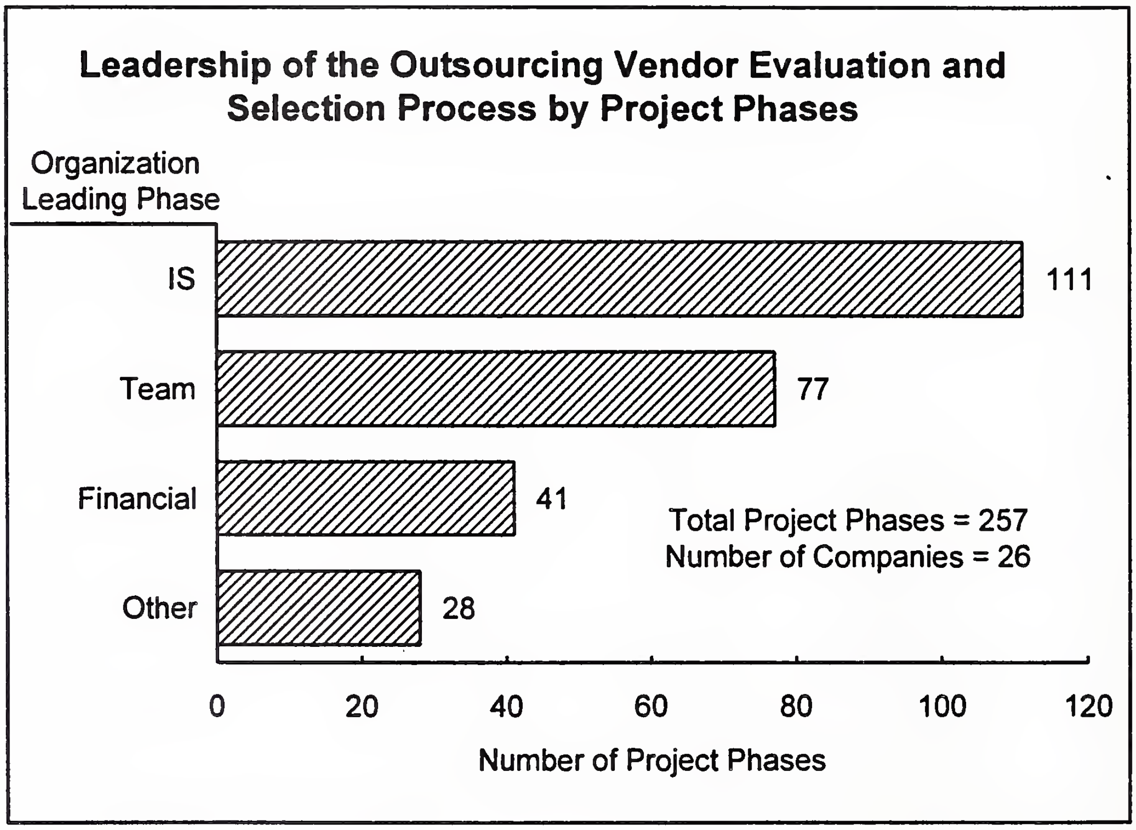
With the exception of the last phase, selection, the “other” category generally consists of legal staff (either internal or consulting) outside process consultants, and occasionally a line operating executive. The latter is particularly true for financial institutions where IS may be part of a larger organization with responsibility for all back-room banking operations. In these instances it would not be uncommon to have the EVP or SVP in charge of operations head-up the evaluation and selection process.

Interestingly enough, the actual decision to go with a particular vendor may be made by a variety of organizations or officers. The sample data indicates that the “other” category, consisting mainly of COOs and CEOs, makes the selection one third of the time. Following COOs and CEOs in decreasing frequency, IS, interdisciplinary teams and finance take responsibility for the selection. However, regardless of who makes the final decision on the recommended vendor, the decision will usually require a formal approval from the CEO, COO, and not infrequently, the Board of Directors. At least one of these three was cited by 80% of the companies in the sample.

Overall, while the CFO or financial organization tends to be the motivator in initiating the decision to outsource, the IS function clearly dominates the management of the evaluation and selection process, either through direct management of the process or leadership in many of the phases.

This concept is supported by Exhibit III-6 which shows the total number of project phases led by various organizations for all companies in the sample.

EXHIBIT III-6



3. The Influence of Finance

Despite the fact IS dominates the management of the evaluation and selection process, the financial function still has considerable influence over the outcome.

Exhibit III-7 shows how respondents rated the impact of the financial function on the outcome of each phase of the evaluation and selection process. The exhibit also includes the names of the organizations most likely, and second most likely, to provide project leadership for the phase.

EXHIBIT III-7

The Impact of Finance on Phases of the Evaluation and Selection Process for Outsourcing Vendors

Phase	Primary Department	Secondary Department	Influence of Finance*
Cost Analysis	Finance	IS	High Influence
Capabilities Analysis	IS	Team	Little or No Influence
Prepare RFP	IS	Team	Medium Influence
Pick Vendors to Bid	IS	Team	Little or No Influence
Run Bidders Conference	IS	Team	Little or No Influence
Develop Selection Criteria	IS	Team	Medium Influence
Communicate with Vendors	IS	Team	Medium Influence
Develop Models	Finance	IS	High Influence
Evaluate Proposals	Team	IS	High Influence
Create Recommendations	IS	Team	Medium Influence
Select Vendor	CEO/COO	IS	Medium Influence

*Influence of Finance on Project Phase

High Influence

Medium Influence

Little or No Influence

Examination of this data leads to the conclusion that while the financial function may not take hands-on management responsibility for very many of the phases of the process, its influence is high in a number of critical steps along the way.

- **Cost Analysis** - As shown in the exhibit, this activity is most likely to be run by finance, and respondents rank finance's influence on the activity as high. Even in situations where this activity is performed by some other organization, finance will ultimately be involved in terms of approving the ground rules and/or verifying the credibility of the output. Thus, finance has a heavy influence on establishing the base case against which vendor proposals will be compared from a financial viewpoint.

- **Model Development** - The vast majority of the models used in the evaluation and selection process deal with the financial aspects of the selection decision. Furthermore, the survey data indicates models have a significant impact on narrowing the field of potential vendors and placing disparate proposals on an equal footing. Thus, finance's direct involvement in the creation of the models ultimately has a heavy influence on the selection.

- **Proposal Evaluation** - Despite the fact that the financial function is not likely to be the organization to run the proposal evaluation activity, respondents rate its influence as high. Finance virtually always participates in the process, and since many of the key evaluation parameters are financial in nature, finance will have the final say in terms of certifying the accuracy of the analysis. As one respondent put it, "The team was totally responsible for comparing proposals and coming up with final recommendations... but in the end, the CEO went to the chief financial officer just to make <u>sure</u> the numbers were *right*."

What emerges then, is a scenario where finance plays the secondary role in the actual management of the process, but has a high degree of influence on the outcome by:

- Setting the basis for the comparison of proposals through its heavy involvement in the cost analysis activity.

- Controlling the algorithmic parameters that will be used to compare the financial aspects of vendor proposals through direct involvement in the development of models.

- Acting as the final authority on the validity of the financial projections coming out the process.

Nevertheless, more than 50% of the respondents indicated IS had the most influence on the final decision when asked to rank key players in the process. Finance was rated the second most influential overall with 50%, followed by the CEO/COO. User management was also included in the ranking process, but, in fact, was a distant fourth. Exhibit III-8 shows the ranking order and the average ranking for each process participant.

EXHIBIT III-8

Ranking of Key Management Groups Influence on Outsourcing Vendor Selection

Organization	Rank	Average Ranking
Information Systems	1	2.0
Finance	2	2.4
CEO/COO	3	2.5
User Management	4	3.3

In summary, it appears the evaluation and selection process is:

- Typically tightly controlled at the senior management level and usually undertaken without significant involvement or influence from user management other than the CEO or COO,
- Generally managed by IS, which has the most impact on the outcome,
- But heavily influenced by finance through stipulation of many of the ground rules and direct participation in key phases of the process.

C
Contract Negotiations

Once the selection has been made, IS typically takes the responsibility for contract negotiations. Exhibit III-9 shows 50% of the contract negotiations for the companies in the sample were conducted by IS. As was the case in the evaluation and selection process, all but three of the companies in the sample used a team approach for negotiations.

EXHIBIT III-9

The companies in the "other" category used a variety of approaches.

- Two turned the negotiations over to consulting organizations, and participated directly as team members only.

- One assigned the negotiations to an operating officer whose primary job function was the management of outsourcing agreements. In effect, this company outsources enough of its noncore operations that they have created a position simply to manage outsourced services on an ongoing basis.

- In one instance, negotiations were actually managed directly by the COO, and in one case, the legal function or legal consultants actually led the negotiation process.

As might be expected, the role played by finance in negotiations varied. The CFO actually managed the negotiations in seven of the twenty-six companies included in the sample, and in only two instances played no role at all in final negotiations. Typical activities assumed by finance as part of the negotiating team included:

- Analysis of the financial terms of proposed vendor contracts.

- Construction of models to project future costs over different resource requirements scenarios.

- Development of performance criteria to permit the objective measurement of contract compliance.

- Negotiation of specific conditions regarding contract payment schedules, penalty payments, etc.

In banking institutions the finance function is likely to have an additional role in the negotiation process; to insure that the contract includes the necessary reporting and control to meet the bank's federal and state regulatory requirements. This was the case in five of the seven banks in the sample.

In general then, finance plays a secondary but important role in the actual contract negotiations; providing support and analysis throughout the process, and frequently participating directly in the negotiations when it comes to the financial and certain measurement aspects of the agreement.

D

Models and Selection Criteria

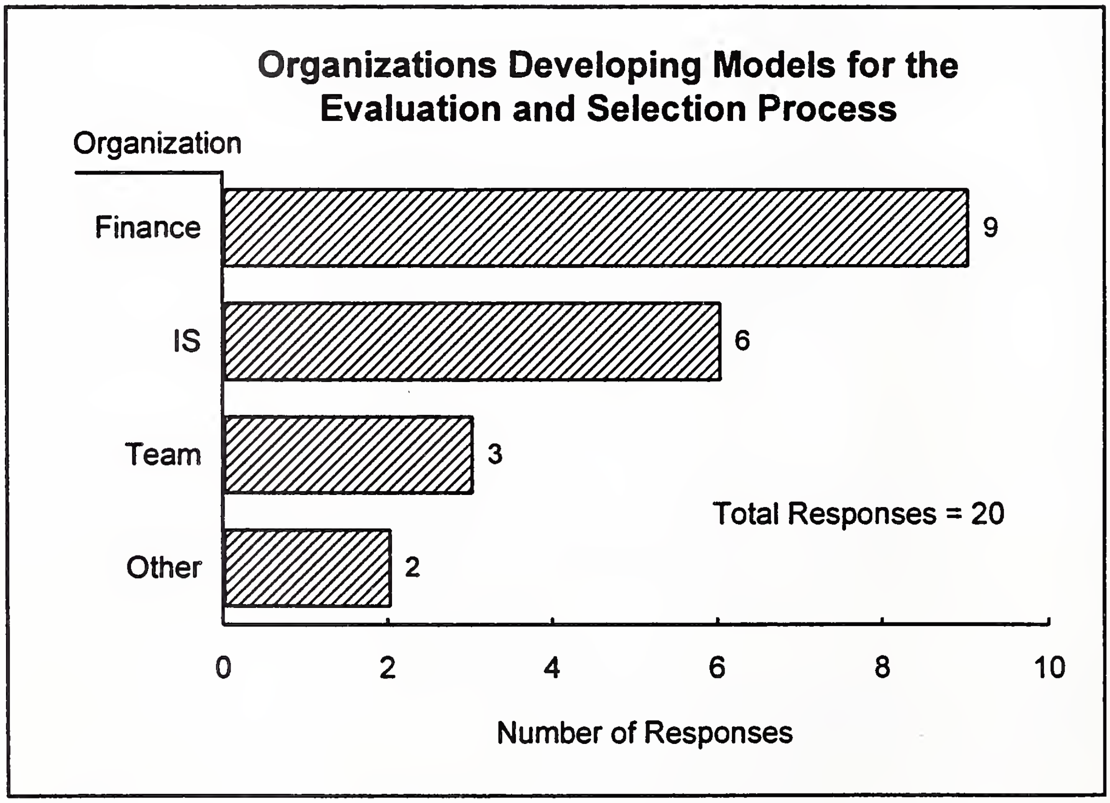
Throughout this chapter there have been several references to the use of models in the evaluation and selection of vendors, as well as in contract negotiations. Analysis of the survey data indicates these models play an important role in selection, since they frequently are used to compare vendors on a variety of parameters that, in effect, represent a company's selection criteria.

This section discusses the types of models used and how information from modeling is combined and weighed with other more subjective data to arrive at a final selection.

1. Models - Types and Use

It is safe to say that virtually every company does some level of modeling in support of the evaluation and selection process. At a minimum, simple spreadsheets are used. However, for purposes of this study companies were asked what they had done in the way of model development beyond the basics. As shown in Exhibit III-5, 20 of the 26 companies (greater than 75%) indicated they had developed some type of formal model to assist in the process. As shown in Exhibit III-10, the finance function plays a significant role in the model development activity.

EXHIBIT III-10



The strong role of finance certainly seems logical, given:

- The heavy emphasis on financial criteria and cost projections in the typical outsourcing agreement.

- The fact that reducing costs was the single most significant factor in deciding to outsource in the first place.

- The skill levels that the finance function usually has in the development of models.

However, most of the models identified in the survey go well beyond the straightforward projection and comparison of the financial aspects of the proposed outsourcing agreement. Exhibit III-11 shows the three types of models most frequently identified and the key parameters used in each.

EXHIBIT III-11

Models Used to Compare Outsourcing Vendor Proposals

Model Type	Description	Typical Parameters
Financial Comparison	Simple comparison of projected costs over the life of the proposed agreement. May include analysis of alternate future scenarios and unit cost projections	- CPU/MIPS - DASD/Gigabits - Development staff/$ - Consulting staff/$ - Network costs/Lines - Software licenses/$
Weighted Scoring	Compares projected costs and assigns values to other desired contract attributes. Develops ranking of vendors based on a weighted scoring of all parameters including financial	- (All of the above) - Technology upgrades - Disaster recovery - Response time/on-line - Schedules/batch - Up time/total system - Development schedule - Staffing/HR items
Application Scoring	Develops comparison of vendor alternatives based on projected cost of deliverables; e.g., transactions, on a per unit basis over the contract life.	- (All cost items above) - Transaction volumes - Transaction patterns - Response time - Transaction integrity

Some general comments regarding models:

- Most are nondeterminant in nature. That is, almost all the models used provide for a way to easily generate alternate scenarios, either by permitting the introduction of alternate cases on a one-by-one basis, or the use of simulations involving probability distributions.

  At a minimum, this capability permits the company performing the analysis to study the best and worst cases scenarios for resource projections and assess the sliding-scale pricing schemes typical of most vendor proposals.

- The models using scoring systems are generally more complex, accommodating subjective judgments on how vendors compare on nonfinancial criteria. The research indicates that companies using these models typically select the "soft" parameters to be scored and establish their weightings using a team approach. The types of proposal items that might be categorized in this manner are:

  - The existence or nonexistence of an RFP requirement in a vendor's proposal, scored on a Yes (1) or No (0) basis and assigned a subjective weighting for scoring purposes.

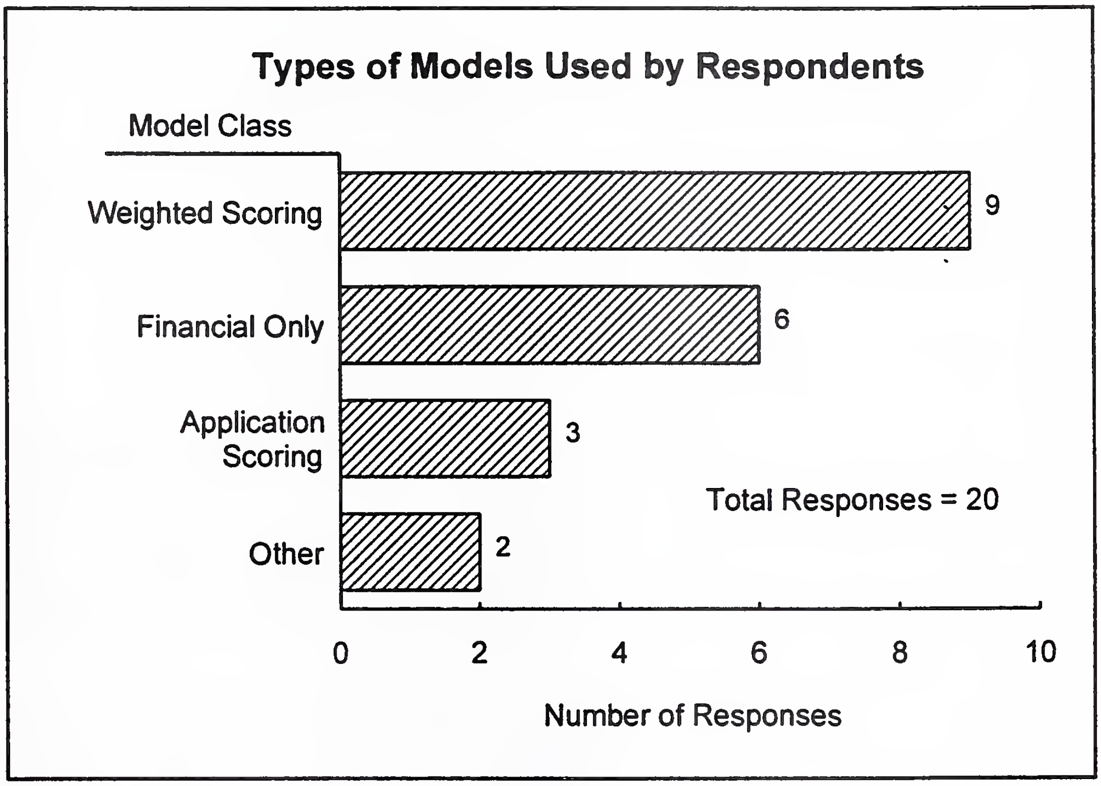
  - A relative comparison between vendors on the quality or depth of their response to a particular requirement. HR transition plans, disaster recovery processes, project management capabilities and the technology capabilities of a vendor might all be compared in this manner. In these situations, vendors may be assigned a relative rank or scaled value for their response on a given item. Once assigned a value, the response is weighted and added into the overall score of the vendor.

- Models involving the development of forecasted transaction pricing by application are clearly the most complex. The underlying assumption is that there is a logical cost allocation scheme that will, in fact, permit the generation of the financial and transaction volume data that is required to construct a base case. Assuming a company can generate this information internally at a meaningful level of accuracy is a stretch. It is even less likely the typical vendor proposal will contain adequate information to permit the generation of comparisons. Nevertheless, three companies in the sample used this type of modeling process, and claim it was the only way they could adequately

bundle together necessary information to compare vendors' costs for applications operations with platform costs for key applications.

As shown in Exhibit III-12, the most popular type of model for survey respondents used some type of weighted scoring as the basis for comparing vendors.

EXHIBIT III-12



If a model is going to be used in the evaluation and selection process, it is critical for vendors to gather as much information as possible about the type of model and key model parameters. There are a number of good reasons.

- Prospects rely on models to put proposals on an equal footing, and at a minimum to narrow the field of potential vendors. In fact, in 80% of the twenty cases where companies used models, the vendor forecasted as optimal by the model was, in fact, selected.

- Models typically reflect a prospect's primary selection criteria. Understanding the criteria that will be used in a prospects model (and how they will be weighted, if the information is attainable) provides a vendor with valuable insight into how the selection will be made, and

permits vendors to offer relevant proposal data in an easy to use and favorable way.

- The parameters used in models are good indicators of the kind of measurement criteria prospects will want to put in place as part of the contractual commitment.

However, it is interesting to note that even when prospects openly share modeling information with vendors, many do not leverage the opportunity. At least half the respondents to this survey indicated that despite their being specific about how they wanted to see proposal data, vendors insisted on presenting it their own way (if at all). Not only does this approach create a high frustration level for prospects, but it exposes the vendor to the very real risk the data will be misinterpreted or misused in the model.

2. Selection Criteria

As noted in the previous section, the modeling process is primarily used to provide a comparison between vendors on key selection criteria, and the kinds of parameters used in the modeling process provide an accurate reflection of the criteria. The question remains—what criteria, beyond that contained in the typical model, plays a role in selection, and what is its relative importance?

To gain insight into the weighting of selection criteria, respondents were asked to identify the key selection criteria that applied in their particular case and discuss any factors that influenced their final selection. Responses were then coded into the following categories for tabulation.

- **Price** - The total projected price on an annual, contract life, or per service unit basis

- **Technology** - The ability to meet or exceed RFP technology requirements for hardware, software and/or telecommunications

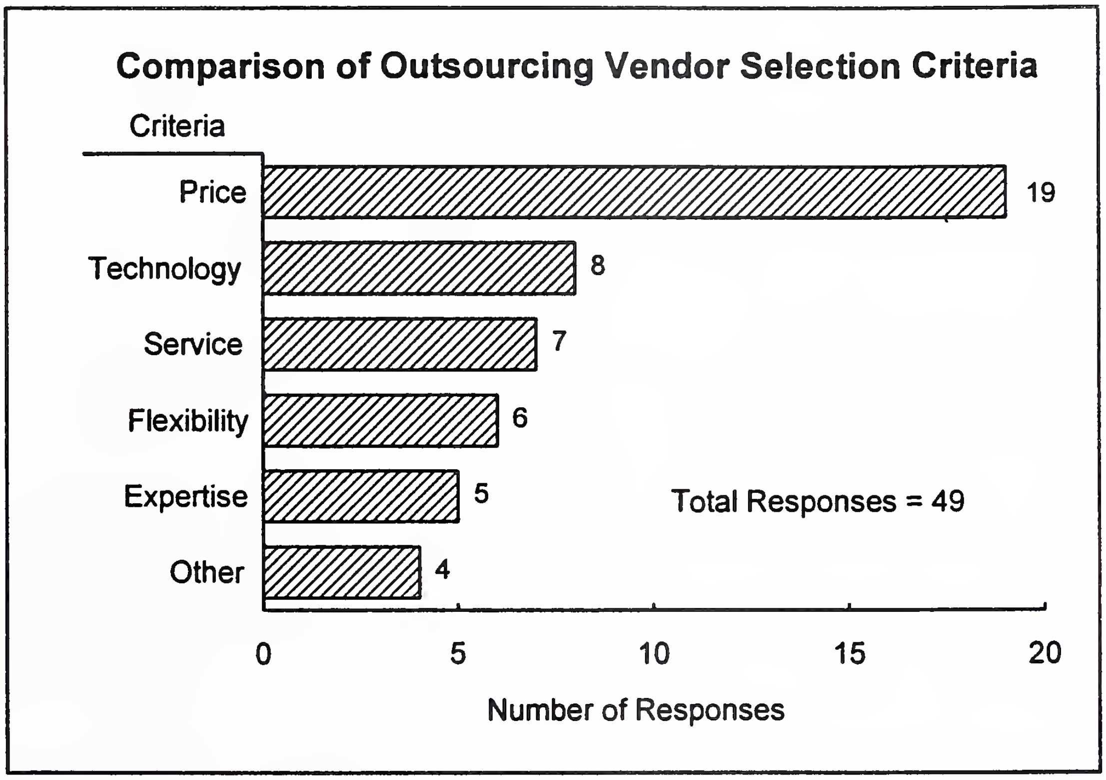
- **Service** - Reputation for or commitment to specific RFP requirements for support services

- **Flexibility** - Perceived or contractual commitment to adjustments in the service levels, etc., to meet unforeseen future requirements

- **Expertise** - Professional services skills to meet contract requirements
- **Other** - Responses not easily categorized into any of the above

Exhibit III-13 shows that price clearly dominates the criteria in most companies.

EXHIBIT III-13



There was some variation in the importance of various criteria as a function of the type of outsourcing being contracted. For example, companies that were outsourcing applications operations were very concerned about technical expertise. Whereas, those firms outsourcing platform operations were primarily focused on hardware and/or software technology as a strong secondary factor to price.

Another way of looking at the data would be to combine the categories of technology and expertise into a single category—technical capabilities. From that perspective the "technical capabilities" category would hold a dominant number two position to price in the weighting of selection criteria, consistent with the rating of the reasons for outsourcing shown in Exhibit III-1.

Finally, it is important to note that in many instances, the narrowing of the field of potential vendors begins at the very front end of the process. In effect, vendors are deselected consciously on the basis of a perceived lack of cultural fit. At least five respondents, when questioned about why particular vendors were not offered the opportunity to bid on a potential partnership, indicated that cultural fit was an issue.

Vendors are also being deselected during the evaluation and selection process itself for cultural reasons or because they refuse to comply with the requests of the evaluating team to honor rules regarding internal channels of communications. Two responds indicated that potential winners were disqualified because of their behavior during the evaluation process.

These two aspects of the selection process are discussed in more detail in Chapter V, *Experience and Benefits*.

E

The Role of Consultants

As pointed out earlier in this chapter, 60% of the companies in the sample used consultants in the evaluation and selection process and/or contract negotiations. In fact, in one instance, a consultant was used to manage the entire process. Although that is probably an unusual circumstance, it appears that consultants make a useful contribution in a number of areas.

In general, the kinds of activities performed by individual consultants or consulting firms in support of outsourcing activities fall into the following major categories.

- **Situation Assessment** - Evaluation of the current systems activity includes such items as; strategy alignment with corporate objectives, costs, service quality and internal systems management processes. This might be extended to include the development of longer-term applications or architectural plans to be used in the preparation of RFPs and vendor discussions.

- **RFP Preparation** - Consultation on, or the actual creation of, RFPs.

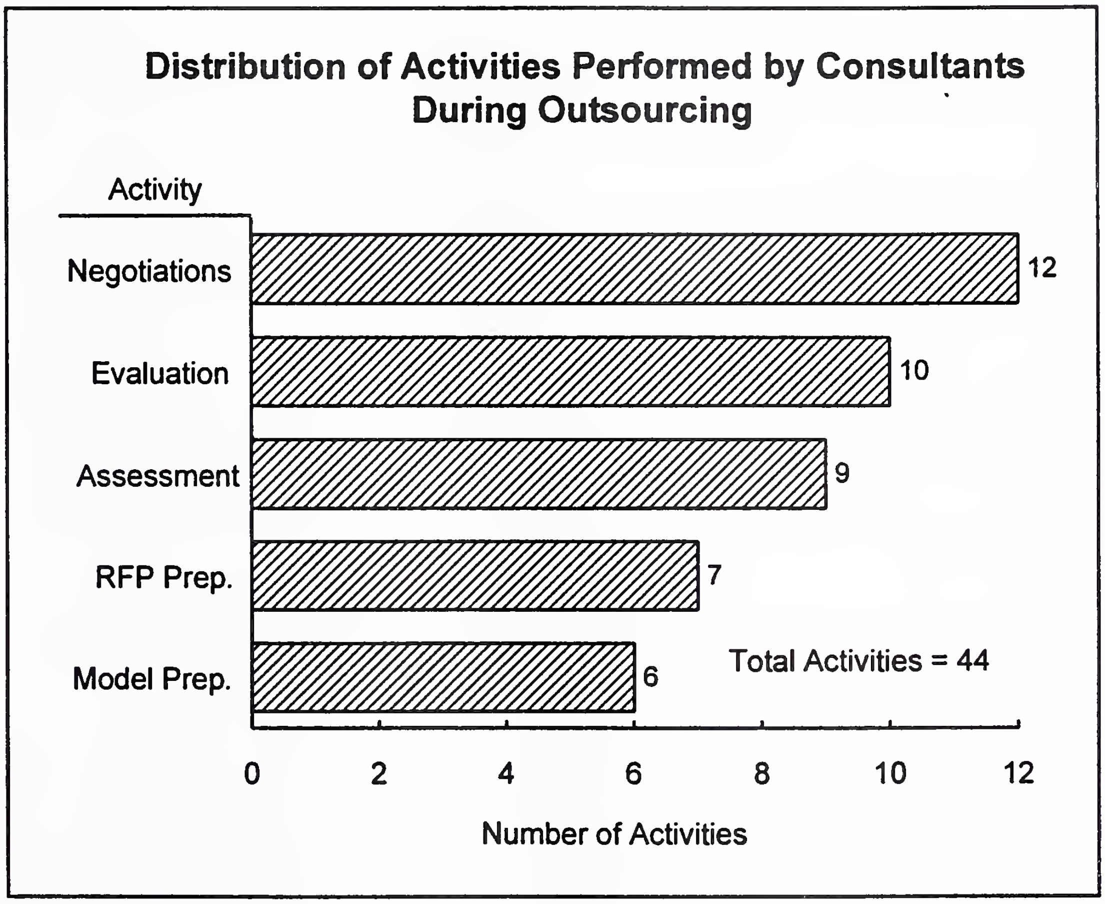
- **Model Development** - The creation of or modification of proprietary models to be used in the evaluation process.

- **Proposal Evaluation** - Consultation on, or participation in, the evaluation of vendor proposals and the development of counter proposals or inquiries for vendors. This activity may culminate in the preparation of formal recommendations.

- **Contract Negotiations** - Consultation, or participation in, contract development and/or negotiations with the selected vendor.

As shown in Exhibit III-14 the consultants were most frequently involved in the negotiation process for companies participating in this study.

EXHIBIT III-14



More than 90% of the companies who used consultants found their services of value and would recommend their use to other firms selecting an outsourcing vendor. Specific areas where respondents feel consultants contribute significant value include:

- Providing and overall methodology for managing the evaluation and selection process

- Preparation of key working documents such as RFPs and contracts
- Identification of opportunities for additional savings in vendor proposals or contracts
- Developing negotiating strategies or actually participating in contract negotiations

But beyond the direct contribution of consultants to specific phases of the process, respondents felt that just having someone on the team who had been through the process before was well worth the fee. As more companies enter into increasingly complex outsourcing agreements involving applications operations and desktop services, the demand for related consulting services should increase.

IV

The Ongoing Management of Outsourcing Agreements

Once the contract is signed and the transition process begins, companies generally move from the project orientation used in the evaluation and selection process to direct assignment of line responsibilities for the ongoing management of the operational relationship with the vendor. This chapter discusses the transition and examines how companies approach the management and measurement activities associated with administering the agreement.

- Section A, *Transition Management*, discusses how companies organize to turnover the outsourced portions of IS, and some of the issues associated with the process.
- Section B, *Ongoing Management Responsibilities*, examines those management activities that are unique to outsourcing agreements and discusses who is likely to assume responsibility for executing them.
- Section C, *Measurement Issues*, looks at the types of metrics used to monitor outsourcing relationships and discusses some of the issues associated with measurement.

A
Transition Management

The transition from internal to vendor management of all or part of the IS function is one of the most underestimated tasks in terms of both time and management effort. It is also one of the most critical in that:

- It establishes initial patterns of communication between the vendor and the internal organization that are likely to continue throughout the agreement.

- A myriad of issues are liable to arise that were not addressed during contract negotiations, forcing on-the-spot resolutions that will set operating precedents likely to last the life of the agreement.

- For the first time, users must become an integrated part of the management process, more often than not, with a vendor they were not responsible for selecting.

Successful handling of this critical phase is usually turned over to the internal organization that will have long-term responsibility for managing the operational relationship. In all but one company in the study, that organization was the IS function.

The time to accomplish transition for companies in the sample varied significantly, ranging from three to four months up to eighteen. The sample is not large enough to draw any general conclusions on the length of the transition phase, but the data does indicate there are a number of factors that will influence it.

- Cases where the outsourcing agreement includes applications operations seem to have the longest transition cycles. Dealing with personnel, process and user management issues associated with a takeover and/or re-engineering of the development activity, clearly extends the time required to stabilize the working relationship.

- Instances where relocations of operating facilities or personnel are involved also have extended stabilization periods.

- Learning curves will slow down the process when the management staff (internal or vendor), responsible for making the partnership work long term, was not directly involved in the negotiating process.

Transition is a critical phase; and while certain aspects of it can be handled by project teams, the effort will be most successful if the overall planning and management of this phase is done by the internal and vendor executives who will end up living with the partnership long term.

B

Ongoing Management Responsibilities

The study identified four key management responsibilities, beyond day-to-day management of operational IS activities, that must be performed in order for the outsourcing partnership to be successful. They are:

- **Communications** - Communications concerning the agreement or changes in the relationship are critical to keeping the partnership on track. They are complex in most situations, involving users, IS senior management and the vendor.

- **Contract Administration** - Depending on the particular contract, the time and effort involved in overall administration varies. It usually includes a variety of activities that must be performed on a periodic basis to assure proper billing and the execution of other tasks such as reporting performance measures.

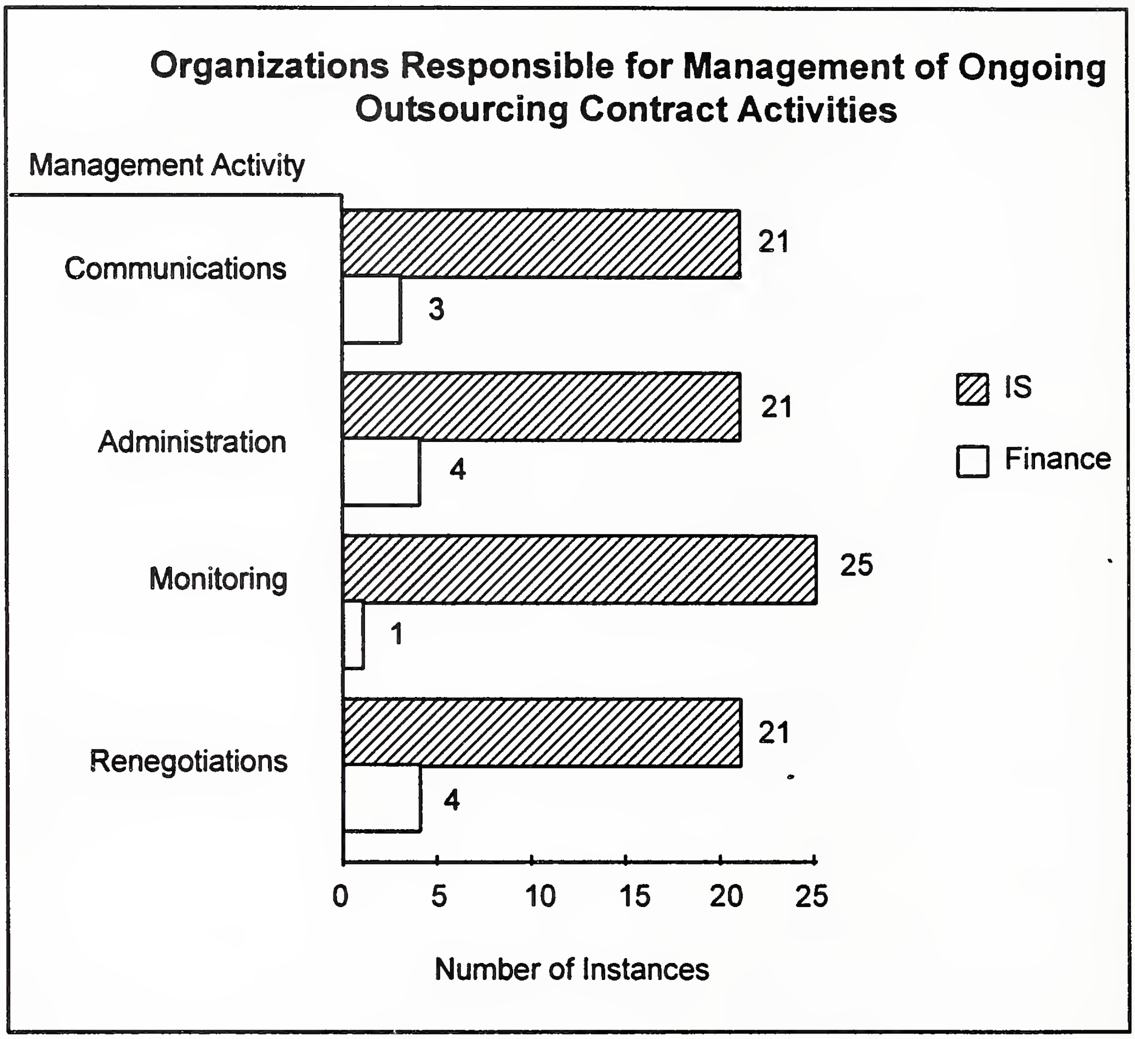
- **Performance Monitoring** - Collecting, analyzing and verifying the data required to measure performance as specified in the contract is a significant task and frequently has financial implications of concern to both parties to the agreement.

- **Renegotiations** - Throughout the life of the contract or at contract renewal, renegotiating service levels, prices and other key aspects of the agreement are facts of life. The way the original contract was written will have a lot to do with how easy it is to accomplish changes. Nevertheless, both parties recognize changes will be required, and need to assume responsibility for ongoing management of the process.

To gain an understanding of how the management of these responsibilities are handled, survey respondents were asked to identify what organizations in their companies held primary responsibility for each of these management activities. If more than one department was involved, they were asked to indicate which organization held the primary, and which held the secondary.

Exhibit IV-1 shows in most instances IS assumes primary responsibility for all of these management activities.

EXHIBIT IV-1



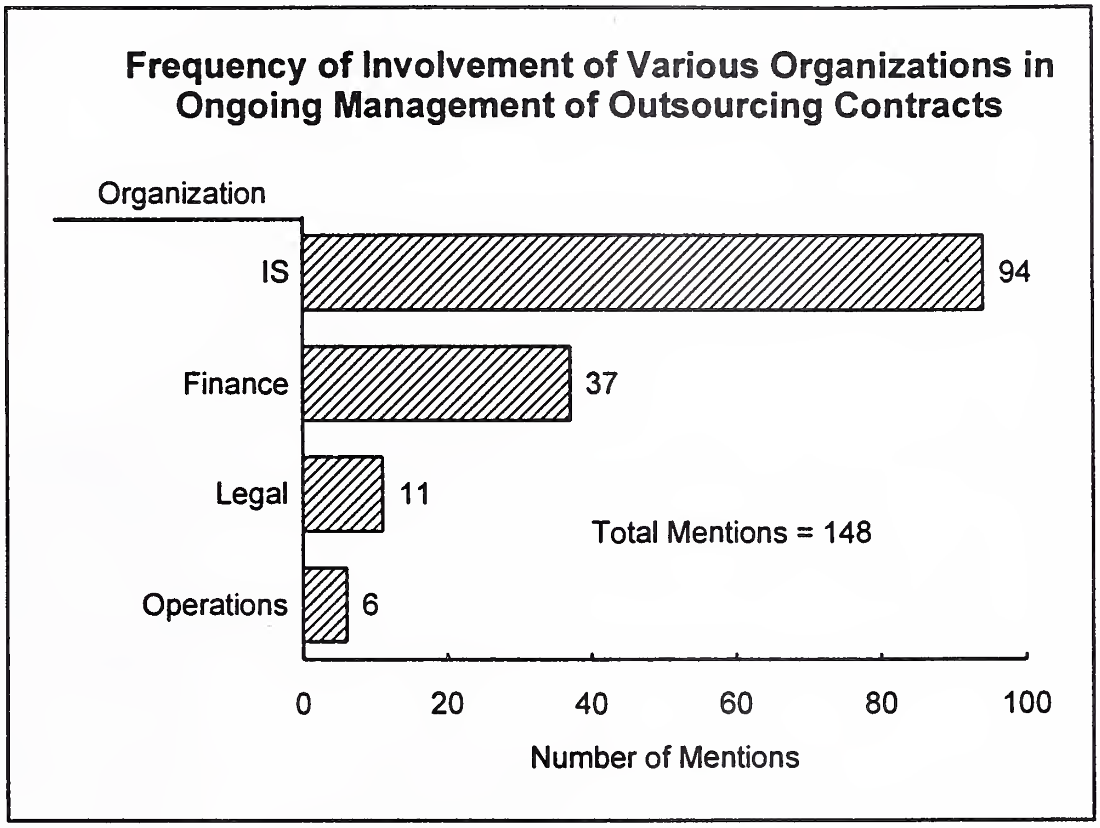
The only other organization taking responsibility for these activities was finance. As shown in the exhibit, direct management by finance was infrequent, averaging only 12% across all four management activities.

However, when a second party participated in the management of an activity it was frequently the financial function. The financial function was directly involved either in the primary or secondary management role as follows:

- 30% - Communications
- 50% - Administration
- 30% - Performance monitoring
- 45% - Renegotiations

So, while seldom formally charged with the direct management of these activities, finance is definitely involved. Further evidence of this fact is provided in Exhibit IV-2 which shows the frequency various organizations were mentioned in the management of ongoing contract activities regardless of whether they were directly in charge or played a secondary role.

EXHIBIT IV-2



The exhibit also points out that legal function usually has some formal role. As might be anticipated, the legal function was mentioned as either primary or secondary with regard to renegotiations.

INPUT concludes the role of finance in managing the ongoing relationship is substantial, but probably not as significant or influential as it is during the evaluation and selection process.

C
Measurement Issues

The approaches to performance evaluation and measurement varied widely between survey respondents and the specific metrics employed. As

pointed out earlier, in most instances, specific metrics are spelled out as part of the contract negotiations and usually reflect the criteria used in the selection process. Virtually 100% of the survey respondents indicated they had some kind of formal measurement system in place.

1. Key Metrics

Clearly the types of metrics put in place vary depending upon what types of outsourcing the contract covers. The key metrics identified in the survey for each type according to INPUT's definitions are shown in Exhibit IV-3.

EXHIBIT IV-3

Key Performance Metrics by Type of Outsourcing

Type	Metric	Description
Platform Operations	- MIPS - Downtime - Response Time - Batch Turnaround - Help Desk Response	- Total MIPS delivered/month, according to contract specification - Hours down per period (usually per/day) against monthly total - Average response to terminal or server initiated transaction - Scoring on meeting turnaround against batch schedules - Time to response per inquiry, sometimes a quality assessment involved
Applications Operations	- Function Points - Project Delivery - Project Staffing	- Function points delivered per monthly schedule - Meeting phased delivery schedules for specific project - Meeting staffing level by skill group per agreed upon schedule

EXHIBIT IV-3 (CONT.)

Key Performance Metrics by Type of Outsourcing

Type	Metric	Description
Network Management	- Response Time - Availability - Change Mgt.	- Per stochastic measurement or against test batch transactions - Availability by node per pre-determined commitment level - Meeting delivery schedules for committed changes
Desktop Services	- Change Mgt. - Help Desk Response	- Meeting delivery schedules for changes in configuration, software upgrades, addition of new systems - Time to response per inquiry, sometimes a quality assessment involved

There are a number of issues associated with each of these groups of measurements that deserve comment.

- **Platform Operations** - The metrics for this type of outsourcing are more clearly established and are the easiest to track and compare to contract requirements. However, problems still exist.
  - Respondents report that factoring changes in volume (transaction or MIP requirements) into the process can be difficult. To deal with this problem, some companies use periodic benchmarks, testing different transactions for batch turnaround or average response time.
  - Measuring response time at an individual terminal is increasingly complex as companies move business transactions from traditional 3270 types of operations to client/server or LAN-based PC operations. When the outsourcer controls the mainframe and/or the network, and does not have control over transaction management at the distributed level, disputes can arise.
  - Help desk measurements present another problem. It is rather straightforward to measure the turnaround time for help desk inquiries, but very difficult to measure the quality or usefulness of

the responses. Some companies use automated systems to provide for direct feedback from users on the quality. Other companies rely on periodic user surveys.

- **Applications Operations** - This is the area where dealing with the metrics is a frustration for both parties. If the use of function were in more common use, this approach might be more popular for measuring development. However, many firms find the investment of installing the systems for defining and measuring function points in their companies, onerous. A variety of other measurement systems exist, such as lines of debugged code delivered, but few have a strong correlation to the value or functionality delivered.

  The net result is that most companies rely on meeting project phase completions on schedule as the key measure of performance. The quality of what is delivered presents another problem. Most companies simply assume that if the system delivers the function required, it meets quality requirements. When the process for specifying requirements is well managed, this is probably an acceptable approach until better quality measurement techniques are available.

  Where companies outsource platform and applications operations, the problem of measurement takes on another level of complexity.

  - The efficiency with which new applications are implemented clearly effects the resources used and response times on the platform side.

  - The introduction of new applications may involve changes in network and user workstation configurations that redefine the overall environment and consequently impact the measurement system.

- **Network Management** - Like platform operations, metrics for most network management activities are more straightforward and subject to some degree of direct measurement through the use of software packages. Respondents who were most happy with management and measurement for networks said they relied heavily on real-time systems that monitored network volumes and performance, identified and isolated network faults, and in some instances forecasted potential network failures.

- **Desktop Services** - Eight of the twenty-six survey respondents indicated they were outsourcing desktop services. All of these companies felt meeting schedules for installations, along with repairs and upgrades, were adequate measurements of performance in terms of meeting operational requirements. But, like platform operations, issues still remain with regard to measuring the quality of hotline response.

Despite measurement problems in some areas, 80% of the companies surveyed felt they had better measurement and control of their systems activities because they outsourced than they had when the function was run in-house. This is not surprising considering:

- The generation of the information required to enter into an RFP process for outsourcing causes many companies to look, either for the first time, or more analytically, at their internal systems function.

- Most outsourcing agreements contain sliding-scale charges based on resource consumption, or performance penalties. Thus, the financial administration of the contract itself imposes more discipline on the measurement process than might be required by simple internal reporting.

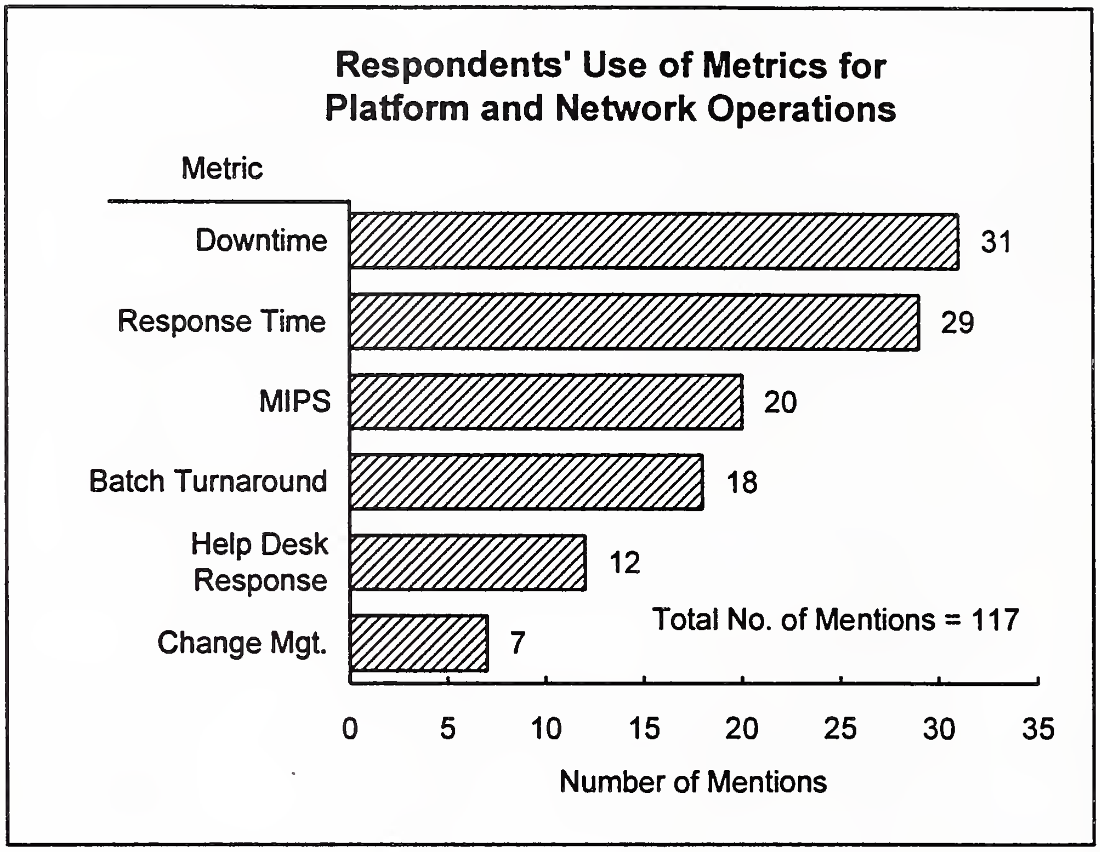
- To meet contract requirements, the quality of the measurement process must be, at least, at a level where both parties can agree that the measurements are reasonably reflective of actual events.

Overall then, adopting outsourcing as a strategy usually imposes more discipline on the measurement of the performance of IS than might occur had the function remained in-house. Even in situations where the metrics are difficult to define or evaluate, having a measurement process in place brings additional discipline.

2. Frequency of Use of Specific Metrics

The frequency that various metrics were used by respondents is shown in Exhibits IV-4 and IV-5. Exhibit IV-4 shows the frequencies for platform and network operations. Exhibit IV-5 shows usage for companies who outsourced applications operations either alone, or in addition to platform operations. In both exhibits the number of mentions is the total count of the number of times that a particular metric was mentioned.

EXHIBIT IV-4



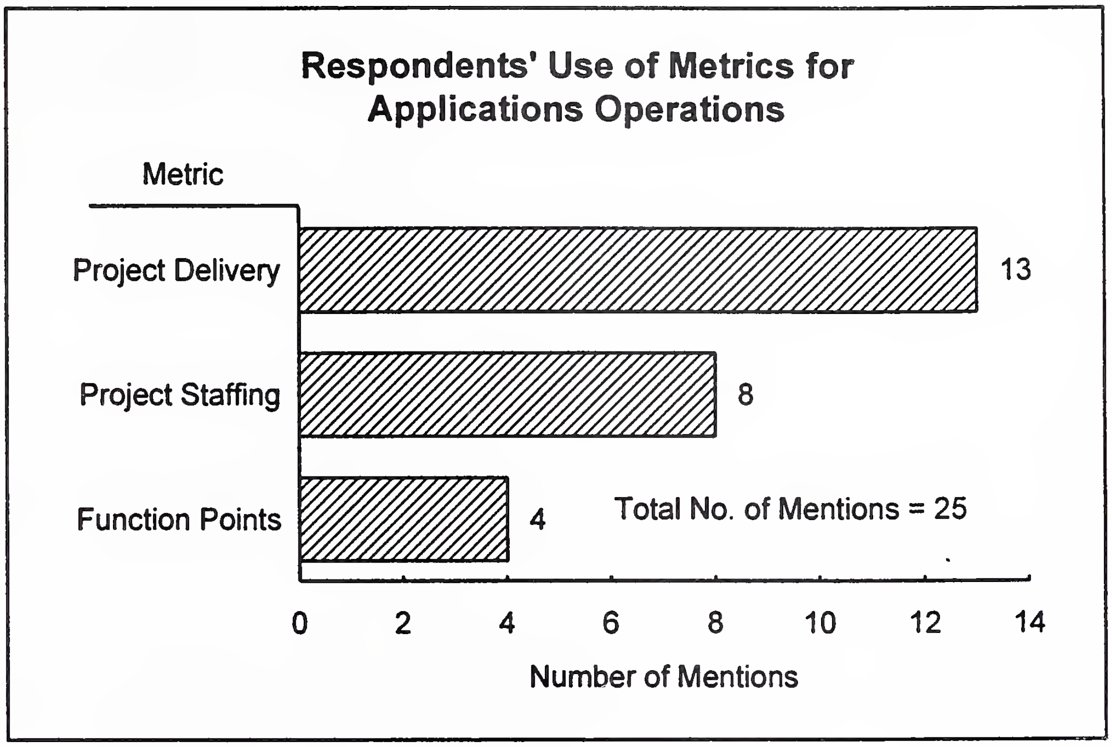
Note: The counts shown for response time, downtime, and help desk response reflect mentions from companies who applied them to network as well as platform operations.

In terms of platform and network operations, the primary metrics focus is on obtaining a measure of overall availability of the system. In the case of applications operations, project delivery was mentioned by all 13 companies who indicated they were outsourcing some or all of the applications development and maintenance function.

However, it should be pointed out that how these specific measurements are used to determine compliance with contract terms may vary significantly from contract to contract.

- In general, volume or usage measurements, typically taken on a monthly basis, are used to establish compliance with minimum delivery guarantees as specified in the contract. They are also used to establish sliding-scale pricing for resources used beyond of those specified in the contract.

EXHIBIT III-5



- Service delivery measurements such as project completions per schedule, average system or network response times and help desk response time or quality, are more typically used to rate performance against service-level commitments.

  Depending on the specific agreement, these service delivery measurements may be used to establish liabilities for penalty payments.

- Finally, some companies use combinations of these measurements to obtain an overall scoring of vendor performance for a given time period. Three of the respondents said scoring was used to establish bonus payments or financial penalties based on the vendor's score falling above or below some acceptable bandwidth of scores specified in the contract.

3. Compliance Reviews

Regardless of the specific set of measures used, the predominant review cycle is monthly. In most instances, the agreed upon measurements are actually generated by the outsourcer. However, there were eight companies in the sample that indicated they prepared the monthly review

package as a joint effort with their vendor. In general, respondents felt a monthly cycle was sufficient for a formal review process, but also set up additional processes, not necessarily required by the contract, to insure that there were no surprises at month-end.

- Weekly, and even daily, status review meetings are common for monitoring and dealing with operational issues that arise in network and platform operations arrangements.

- Some companies report performance statistics daily on their network, and make them available to anyone who wants to see them.

- Most companies establish "alert" systems that can be triggered by users, IS or the vendor to deal with issues that require an on-the-spot resolution.

So while most agreements use a relatively simple set of metrics to provide the data for assessing contract performance, the ways in which they are packaged, processed and used in managing them are many.

Finally, it appears in most instances, as the relationship matures, regular monthly meetings become formal forums for the presentation of status. Making the agreement work and resolving even critical issues occurs behind the scenes.

V

Experience and Benefits

Regardless of how the vendor was selected or the processes used to manage the outsourcing partnership, the real issue is whether the relationship delivers the anticipated benefits. This chapter addresses that question, and also examines some of the difficulties that buyers have in the evaluation and selection process.

- Section A, *Overall Satisfaction*, analyzes the satisfaction of survey respondents with their current outsourcing agreements.

- Section B, *Benefits*, addresses the anticipated benefits and to what degree they have been achieved.

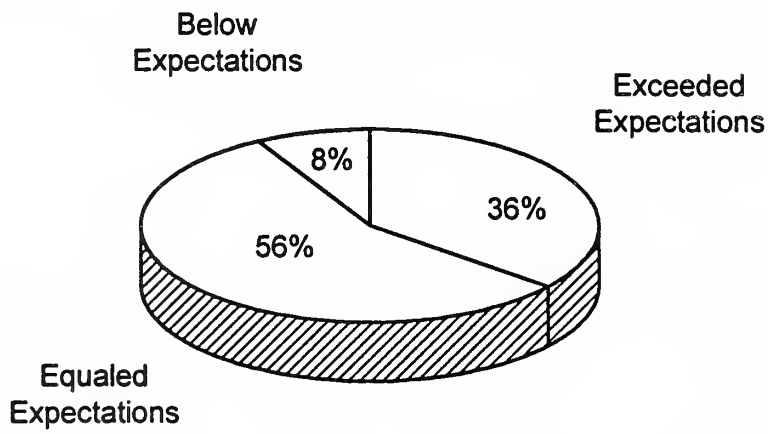
- Section C, *Lessons Learned*, reviews those aspects of the evaluation, selection and management of outsourcing partners that respondents would change if they had the opportunity.

A
Overall Satisfaction

As shown in Exhibit V-1, the vast majority of respondents (23 of 25) felt their current agreements met or exceeded their expectations in terms of delivering the anticipated benefits. (One company indicated that it was too early to tell.)

EXHIBIT V-1

Respondents' Overall Satisfaction with the Results of Their Outsourcing Agreements



Proportion of Sample of 25

However, satisfaction levels do vary based on the types of outsourcing provided.

- Of those nine companies who said their agreement exceeded expectations, only one had outsourced applications operations.
- Both companies that expressed dissatisfaction with their agreements had outsourced the applications function.

While not statistically significant, these results do indicate companies that outsource the applications function alone or in conjunction with platform operations may be overly optimistic about the impact outsourcing will have on improving the development activity. The one company that felt quality on the development side exceeded expectations, had in fact, outsourced to a major accounting firm for that service.

But regardless of the potential problems in the applications area, it appears that most companies are satisfied that they made the right decision, and in fact, are more pleased with the arrangement than they had anticipated.

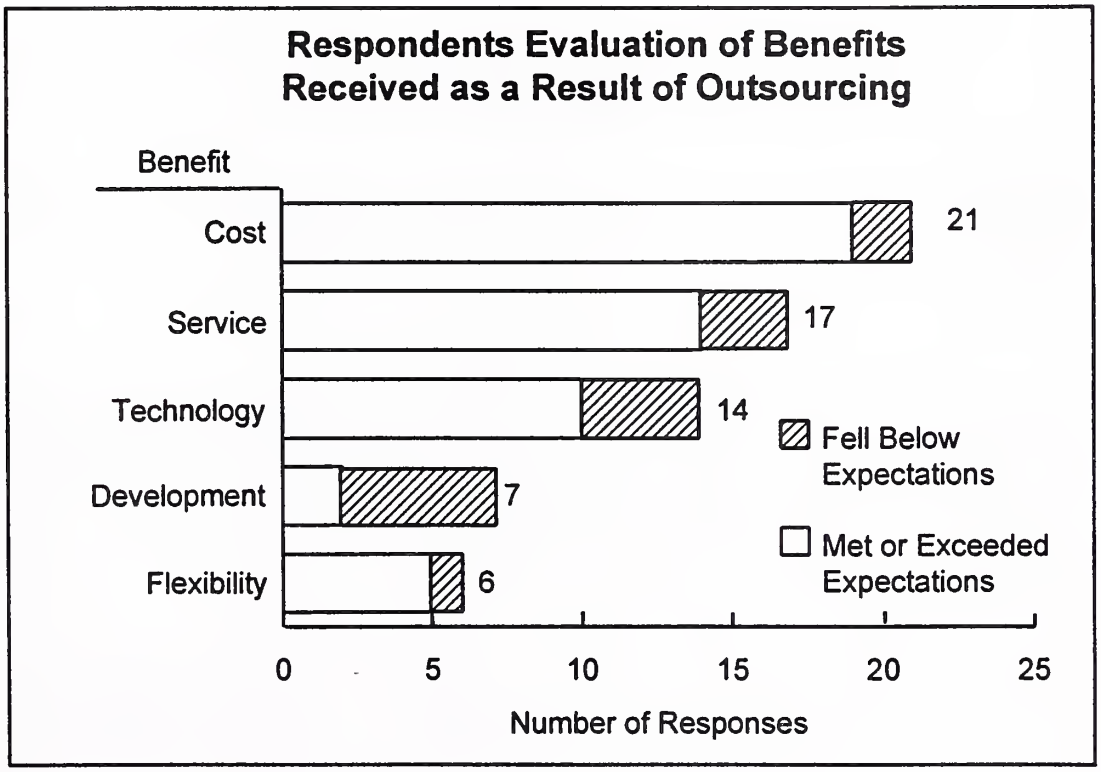
B
Benefits

As discussed in Chapter III, most companies anticipated reduced costs either in total, or on a per unit basis as the primary benefit of outsourcing. In fact, most companies in the survey are achieving or exceeding their goals in the financial area. Other benefits respondents hoped to obtain included:

- Flexibility in acquiring resources - hardware, software, personnel
- Improved systems development capabilities - either improved quality and/or more rapid development cycles
- Access to new technology
- Improved service levels - response time, availability, etc.

Exhibit V-2 gives an indication of how companies in the sample felt expectations were met in each of these areas.

EXHIBIT V-2



In addition to a high degree of satisfaction with the cost savings achieved, the vast majority of companies who anticipated improved service levels met their objectives.

- One firm reported the improvement experienced in uptime and on-line response was significant enough that they were able to obtain additional savings through improved productivity of clerical staff.

- Another indicated that the improved service levels resulted in their being able to achieve measurable improvements in the quality of their customer service.

Of the fourteen companies that commented on technology objectives, at least four were disappointed with performance. Three of these companies feel they will meet the objectives eventually, but were disappointed with the pace at which new technology is being introduced by the vendor. INPUT believes in many cases, contractual commitments regarding the introduction of new technology loosely stated and difficult to measure, sometimes setting up unrealistically high expectations.

Respondents reported their lowest satisfaction levels with the applications operations aspects of their agreements. The three major areas of complaint were:

- The failure of vendors to meet commitments on applications taken over during the transition phase

- The inability of vendors to supply the professional skills promised within contractually committed time frames

- Missed schedules

However, as was the case with those who were disappointed with the pace of new technology introduction, all but one of companies commented negatively about systems development, and that company felt the problem would be worked out over time.

C
Lessons Learned

Most companies appear to make it through the evaluation, selection and negotiation processes with minor difficulties. But many found dealing with vendors during some phases of the process difficult; and would do things differently if they had it to do over again. The following analysis of respondents views on these subjects provides insight from the buyers' view that should assist outsourcers in improving their performance throughout the process.

1. Process Difficulties

From a buyer's viewpoint, the largest difficulties arise in analyzing responses to RFPs and during negotiations. Exhibit V-3 details the specific problems encountered during these phases, and provides an estimate of the importance of the problem based on the number of times mentioned by respondents.

EXHIBIT V-3

Problems Encountered During the RFP and Negotiating Phases of the Outsourcing Process

Phase	Problem/Issue	Importance*
RFP	Failure of vendors to respond directly to RFP	Very High
	Inability to compare vendor responses	Very High
	Managing vendor communications	High
	Validating claims made in vendor proposals	Medium
Negotiations	Establishing service-level measurement criteria	Very High
	Defining responsibilities for specific processes	High
	Mapping proposal terms into contract terms	High
	Maintaining focus on important issues	Medium

* Very High High Medium

a. RFP Process

The biggest complaint registered by buyers was their frustration in many instances, with vendors that failed to comply with requirements, or responded in an indirect or oblique way. Buyers also complained that vendors responses frequently read like “counter-proposals”, offering services of little interest or specifically excluded from consideration by the RFP. When these situations occur, additional considerations in the bidding process are required to suppress rising frustration levels.

Buyers also had more difficulty comparing vendor responses than they had anticipated. Some of this difficulty is undoubtedly due to quality problems with the RFP. But, the fact that vendors fail to address key points or include unsolicited offerings in their proposals certainly complicates the problem. Making comparisons between vendors proposal terms for applications operations was particularly difficult for most buyers. Looking at function point estimates from one vendor and trying to compare it to proposed head count from another poses a nontrivial problem at best.

Respondents cited difficulty in managing vendor communications throughout the evaluation and selection process as the third most significant problem. Most companies establish a formal team and set up rules about communications early in the process. At least seven of the companies participating in the survey had difficulty with vendors making “end runs” outside the defined chain of communications for political lobbying or marketing purposes.

b. Negotiations

During the negotiation phase, establishing the service measurement criteria and processes appears to cause the greatest difficulty. More than half the respondents listed it as number one. But it was closely followed by the difficulty of defining who would assume responsibility for the management of all or part of a specific process, and who would make the ultimate decisions on a variety of issues.

Finally, some respondents felt the language used in a vendor’s proposed contract was far enough removed from the language used in the same vendor’s proposal document that it was difficult to verify that both documents were addressing the same objectives and issues.

There are obviously some actions vendors can take to minimize the level of difficulty that their approach to the process causes prospects. Certainly, vendors cannot afford to take a totally unique approach to every prospect, but some greater level of tuning of the standard approach to a prospects needs and requirements would probably payoff in terms of reduced sales cycle time, and maybe even bids won.

2. Doing it Differently

Sixteen of thetwenty-six companies (60%) in the sample felt that if they had it to do over again, they certainly would do some things differently.

Some of the things they would change reflect the need to address the problems they encountered in dealing with vendors. However, other changes in approach result from a recognition that they could have been better prepared and/or organized before entering into the process.

The variety of responses on this issue was quite broad, and covered all aspects of the process through the transition phase. Exhibit V-4 categorizes the information according to whether the change would apply prior to initiating evaluation and selection, during the evaluation and selection, during negotiations or during the transition.

EXHIBIT V-4

Things Respondents Would Do Differently as Part of the Outsourcing Process

Phase	Change in Strategy (Would Have)
Pre Evaluation/Selection	• Undertaken formal measurement process of current systems activity prior to starting process • Investigated process and legal consultants • Selected stronger negotiating team
During Evaluation/Selection	• Spelled out development requirements more specifically • Identified specific hardware and systems software changes required in RFP • Specified preferred metrics and financial conditions • Insisted proposals address RFP requirements

EXHIBIT V-4 (CONT.)

Things Respondents Would Do Differently as Part of the Outsourcing Process

Phase	Change in Strategy (Would Have)
During Contract Negotiations	• Insisted that vendor's proposed account team, and company internal team were present • Simplified processes for change management - contract and operating environment • Identified responsible parties for all processes • Invested more time in termination aspects/options
During Transition	• Frozen the environment prior to entering into transition phase • Assigned more responsibility directly to people who would manage the ongoing process - less to the project team • Maintained better communications with internal staff and user organizations

The most frequently mentioned changes in process related to:

- Investing more time in understanding the current environment from a technical and financial viewpoint before entering the evaluation and selection process
- Being more specific about requirements and proposed metrics in the RFP.

Several of the other changes that companies claimed they would make actually could be categorized under the heading of "taking charge of the process." Examples of these types of changes include:

- Insisting that vendors respond to the requirements
- Declaring the company's position on metrics and financial preferences
- Insisting that responsibilities for key decision be specifically assigned

- Specifying required technology changes and associated time frames
- Demanding more clarity on the systems development aspects of the agreement

Regardless of the difficulties that buyers experienced going through the process and things they might have done differently, it's important to remember that all but two felt the end results were meeting or exceeding their expectations. Furthermore, at least six mentioned they were considering expanding their agreements to cover aspects of the systems function that were not originally contracted.

A

Survey Participants

Twenty-five of the 26 companies participating in this study are listed below. One company did not wish to be identified.

- American Tobacco
- Bethlehem Steel Corporation
- Beverly Enterprises
- Brenton Banks
- Comshare Corporation
- Continental Bank
- Delmonte Foods
- Eckerd Corporation
- FLHB of San Francisco
- Federal Local Bank
- First Michigan Bank
- Freeport McMoran
- Jackson National Life
- LSI Logic, Inc.
- Nielsen
- Pathmark Stores, Inc.
- Philips Semiconductor
- Quotron Foreign Exchange
- Riggs National Bank
- Southland Corporation
- Sun Company, Inc.
- Union National Bank
- United Technologies
- WABCO
- Wheeling Pittsburgh Steel
- Zale Corporation

B

Survey Questionnaire

The following questionnaire was used to gather information for this study.

User Questionnaire: The Role of the CFO in Outsourcing Decisions

The following survey is being conducted to gain insight into the role played by chief financial officers (CFOs) in decisions involving the outsourcing of information systems activities. The information will be used in the preparation of a written analysis. Information provided by individual study participants will not be identified by company name within the report without prior approval.

A. Organization and Background

1. Where do you report in the organization?

☐ CEO ☐ COO ☐ Executive/Managing Committee ☐ Other ________________

2. At the time the decision was made to outsource did the systems function report to you?
_____ (Y/N) If not, then to whom?

☐ CEO ☐ COO ☐ Executive/Managing Committee ☐ Other ________________

3. Were you directly responsible for initiating the examination of outsourcing?
_____ (Y/N) If not, then who was?

☐ CEO ☐ COO ☐ CIO ☐ Other ________________________________

4. If not the CIO, was the CIO consulted with on the decision to examine outsourcing?
_____ (Y/N)

5. Was the decision to examine the outsourcing of IS part of an overall corporate program to downsize or restructure operations?
_____ (Y/N)

6. On a scale of 1-5 (5 High) please rate each of the following reasons why the outsourcing of IS was considered.

_____ Cost reduction
_____ Perceived lack of responsiveness on the part of IS to user requirements
_____ Perceived lack of IS technical expertise to respond to changes in technical strategy
_____ Direct solicitation of outsourcing vendor
_____ Other: ________________________________

B. Outsourcing Decision Making Process

7. Was a team created to evaluate outsourcing alternatives and vendors?
_____ (Y/N)

Please indicate which of the following activities were part of the evaluation and selection process, what organization and/or officer took primary responsibility for each, and to what degree on a scale of 1-5 (5 High) the financial organization participated in the particular activity. *(If any of the specified activities were not performed answer "N" in column "a". Additional activities not specifically identified should be added to the bottom of the table.)*

	(a) Y/N	(b) Activity	(c) Organization	(d) (1-5)*
8		Overall management of the process		
9		Analysis of current systems costs		
10		Analysis of current systems capabilities and future requirements		
11		Preparation of requests for proposal		
12		Selection of vendors invited to submit proposals		
13		Bidding conference		
14		Development of vendor selection criteria		
15		Interaction with vendors during proposal development		
16		Development of models for the evaluation of proposals		
17		Proposal evaluation		
18		Development of formal recommendations		
19		Vendor selection		
20				
21				

*Rating on a scale of 1-5 of the importance of the financial function in the activity.

22. Once the selection was made, who took leadership in the actual contract negotiations, and what was the role of the financial function, if any?

____

____

____

23. Were outside consultants or other third parties used in the selection or contracting process? _____ (Y/N) If so, please describe for what activities and who selected them?

____

____

____

24. If specific models were used in the evaluation and selection process could you please indicate who developed the model, describe the purpose and key parameters for each?

Description/Developer	Purpose	Key Parameters

25. From the perspective of the financial organization what are the key criteria that should be used in making the selection of an outsourcing vendor?

____

____

____

26. Overall, how would you rank the following organizations in terms of their *influence* in the selection of your outsourcing vendor? (Please number the following in rank order from 1 to 5.)

_____ Finance
_____ Information Systems
_____ User Operational Management
_____ CEO/COO
_____ Other: ____

C. On-Going Management Responsibilities

Please indicate which organization will assume responsibility for each of the following activities associated with the on-going management of the outsourcing relationship. *(If responsibilities will be shared, please record a "P" for primary, and "S" for secondary.)*

	Responsibility	IS	Fin.	Oth.	Other-Description
27	Communications concerning the agreement				
28	Overall contract administration				
29	Monitoring contract service levels				
30	Contract renegotiations				
31	Other:				

32. Have specific metrics been put into place for measurement of vendor performance?
_____ (Y/N) If so, could you please describe them?

____
____
____

D. Experience and Benefits

33. Which of the following best describes your current feelings regarding the benefits obtained as a result of the outsourcing agreement?

☐ Exceed expectations
☐ About equal expectations
☐ Fall below expectations
☐ Too early to tell

34. Could you please describe the anticipated benefits, financial and other, and how they have varied from your expectations.

____

____

____

35. Are there aspects of the selection process or on-going management of the contract that you would have done differently or intend to change?
_____ (Y/N) If yes, please describe.

____

____

____

____

____

____

36. What was the most difficult aspect of dealing with vendors during the selection and contracting process?

____

____

____

E. Contract Summary

37. Who was selected as the vendor? ______________________________

38. Which of the following IS activities were ultimately outsourced?
(Please indicate all that apply.)

- ☐ Platform operations
- ☐ Network management
- ☐ Applications operations
- ☐ Desktop services
- ☐ Other: ____

39. What was the overall estimated value of the contract? _______________ ($Millions)

40. What is the contract life in years? _____

I want to thank you for participating in the survey. A complimentary executive summary outlining the findings will be sent to you early in 1994.

C

Definitions

The following definitions of terms are applicable to this report and were taken from *INPUT's Definition of Terms - 1993*, a publication of INPUT's U.S. Market Analysis Program. A copy of the complete set of industry definitions may be obtained by contacting any INPUT office.

- *Applications Operations* - The vendor manages and operates the computer systems to perform the client's business function, and is also responsible for maintaining, or developing and maintaining, the client's application systems.

- *Desktop Services* - The vendor assumes responsibility for the deployment, maintenance and connectivity among the personal computers and/or workstations in the client organization. The services may also include performing the help-desk function. Equipment as well as services can be part of a desktop services outsourcing contract.

- *Network Management* - The vendor assumes responsibility for operating and managing the client's data communications systems. This may also include the voice communications of the client. A network management outsourcing contract may include the full costs of the communications services and equipment plus the management services.

- *Outsourcing* - Outsourcing involves the operation and management of all or a significant part of the client's information systems function under a long-term contract. These services can be provided in either of two distinct submodes where the difference is whether the support of applications, as well as data center operations, is included.

- *Platform Operations* - The vendor manages and operates the computer systems, to perform the client's business functions, without taking responsibility for the client's application systems.